THE BANKRUPTCY REFORM ACT
REVISION OF THE SALARY FIXING PROCEDURE FOR BANKRUPTCY JUDGES
ADJUSTMENT OF DEBTS OF POLITICAL SUBDIVISIONS AND PUBLIC AGENCIES AND INSTRUMENTALITIES

HEARINGS

BEFORE THE

SUBCOMMITTEE ON IMPROVEMENTS IN JUDICIAL MACHINERY

OF THE

COMMITTEE ON THE JUDICIARY UNITED STATES SENATE

NINETY-FOURTH CONGRESS

SECOND SESSION

ON

S. 235 and S. 236

BANKRUPTCY REFORM ACT

S. 582

REVISION OF THE SALARY FIXING PROCEDURE FOR BANKRUPTCY JUDGES

MAY 1, 1975

AND ON

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OCTOBER 31, 1975 AND NOVEMBER 4, 1975

Part III

Printed for the use of the Committee on the Judiciary

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FRIDAY, OCTOBER 31, 1975

TUESDAY, NOVEMBER 4, 1975

APPENDIX

ALPHABETICAL LISTING—S. 2597

S. 235 AND S. 236
THE BANKRUPTCY REFORM ACT

STATEMENT OF FRANCIS F. QUITTNER, REGARDING S. 235 AND S. 236, 94TH CONGRESS, 1ST SESSION

I am Francis F. Quittner, a practicing attorney in the City of Los Angeles, California. The statement that hereinafter follows pertains only to the subject of Appellate Review in Bankruptcy and to no other portions of the proposed Bankruptcy Act. Although as will later appear I am a member of various important Conferences and other organizations interested in improving bankruptcy administration. I am not speaking officially for any of these organizations but only in my proper person. Views herein expressed are entirely my own and bear no official endorsement by any organization or Conference.

I have practiced in the field of insolvency, specializing in corporate reorganization matters in Los Angeles, California and will on March 22, 1976 celebrate my 50th year in the practice of law. I have been a member of the National Bankruptcy Conference since 1952 and am still very active in that organization. In that Conference I served on the Executive Committee for about nine years. I also served as Chairman of certain Committees. I devote most of my activity to the Committee on Arrangements and Reorganization. I am a member of the Bankruptcy Committee of the Ninth Circuit Judicial Conference. I was appointed in 1954 and am still a member of that Committee. I was its Chairman from 1954 to 1964. Additionally I participated extensively in some of the drafting of the Bankruptcy Act of 1938 under the leadership of the late Rueben Hunt of the California Bar. During my Chairmanship of the Ninth Circuit Judicial Conference Bankruptcy Committee I proposed numerous amendments to the Bankruptcy Act which were approved by the Judicial Conference of the United States and the Administrative Office which are now part of the Bankruptcy Act in effect as of this time. I performed a similar function as a member of the National Bankruptcy Conference. I am the author of the proposal to consolidate Chapters X and XI into a single Chapter and have lectured and written on the subject in which the proposed merger was referred to as Chapter X½, and is the basis of the now proposed Chapter VII. I have many other credits too numerous to mention as to my activity and participation in improving bankruptcy administration.

An invitation was extended to me to appear before your Committee on October 30th as a witness. However, I was advised by a member of your staff that the message inviting me was left at a hotel in New York at which I was staying on the 28th of October, confirming the invitation to me, but unfortunately it was never delivered. However, a member of your staff advised me by letter that although the Committee could not now have the benefit of my testimony in person that there was an opportunity for me to submit my views to the Subcommittee for enclosure in the record. I, therefore, have taken advantage of this invitation and will proceed with my argument.

Of all of the provisions of the new proposed Bankruptcy Act none appears to be more controversial at the present time than the method of conducting appeals from the Bankruptcy Court's Orders and Judgments. The Committee of the National Bankruptcy Conference on establishment of a separate Bankruptcy Court reported to the National Bankruptcy Conference at the Mid-Year Meeting in April, 1975 (which Committee is chairmaned by George M. Treister) as follows:

"Appeals from the Bankruptcy Court would run in the first instance to an Appellate Department of the Bankruptcy Court consisting of one or more three member panels of Judges designated by the Chief Judge of the Circuit from among the Bankruptcy Judges. The Appellate Department would not be a separate Court. Assignment to it would not be on a permanent basis but the appointing Chief Judge would rotate the appointments depending upon availability of the Bankruptcy Judges, how much appellate business there was, etc."

At the meeting of the National Bankruptcy Conference in Chicago, Illinois in April of 1975 this portion of the report was rejected and in its place a resolution was adopted as follows:

Appeals from the Bankruptcy Court to Court of Appeals. Appeals from the new Bankruptcy Court should run directly to the Court of Appeals, rather than to the District Court or to an appellate division or department of the Bankruptcy Court.

This was followed up by the Drafting Committee of the National Bankruptcy Conference and is found in their draft which has been submitted to you under Section 2–210 *Appeals and Reviews* .In this draft it is proposed that the U.S. Court of Appeals have jurisdiction of appeals from judgments and orders of the Bankruptcy Courts.

The Bankruptcy Committee of the Ninth Judicial Circuit Conference, in spite of the action taken by the National Bankruptcy Conference, presented a resolution to the Ninth Circuit Judicial Conference which was held in San Francisco, California in July of 1975 as follows:

B. RESOLUTION RE METHOD OF APPEALS FROM THE BANKRUPTCY COURT

Be it resolved, That the Ninth Circuit Judicial Conference endorse the concept of an intermediate appellate tribunal to hear appeals from judgments and orders of judges of the bankruptcy court which tribunal shall be composed of three judge panels of bankruptcy judges selected by the chief judge of the court of appeals of the circuit in which the case arose and which panels are to be convoked on an ad hoc basis.

I was the sole dissenter and filed a minority report with the Judicial Conference. My chief objections to the resolution was based upon the fact that the resolution proposed that the three Judge panels be composed only of Bankruptcy Judges. Instead I suggested that the Appellate Department be a separate Court instead of a division of the Bankruptcy Court and that it be composed of a panel of three judges without limitation designated by the Chief Judge of the Circuit or the Chief Justice from among any Judges of the United States. This could include active, retired or Senior United States Circuit, District Judges or Bankruptcy Judges. I also argued that we have no right to assume that all Judges except Bankruptcy Judges are ignorant of the Bankruptcy law and, therefore, only Bankruptcy Judges should sit in this judgment. I also argued before the Conference that it would be important under our judicial system not to have an Appellate Court consisting only of colleagues of the Bankruptcy Judge who made the order or judgment appealed from.

The resolution of the majority report of the Committee was rejected by the Ninth Judicial Circuit Conference and in its place my proposed amendment to the resolution was adopted. The following resolution was adopted by the Ninth Judicial Circuit Conference:

That the Ninth Judicial Conference endorsed the concept of an intermediate appellate tribunal to hear appeals from judgments and orders of judges of the Bankruptcy Court which tribunal shall be composed of three judge panels of federal judges (including bankruptcy judges) selected by the Chief Judge of the Court of Appeals of the Circuit in which the case arose.

I disagree in one minor respect with the resolution adopted by the Ninth Circuit Judicial Conference in that the words "ad hoc" was deleted, it being the thought of the judges that a permanent intermediate appellate court should be created. I believe that the original suggestion of the Ninth Circuit Conference Committee and the Committee of the National Bankruptcy Conference that the Court on an ad hoc basis would be much more satisfactory to meet the needs of hearing appeals from the orders of the Bankruptcy Court.

I would have preferred to be a complete optimist and support the view of the National Bankruptcy Conference that all appeals from judgments of orders of the Bankruptcy Court be taken directly to the U.S. Court of Appeals. I label this as the impossible dream. However, after having served as a delegate to the Ninth Judicial Circuit Conference and a member of its Bankruptcy Committee for 25 years, I would hope to believe that I understand the views of the United States Judges. Over the course of years a tremendous number of District Court Judges constantly requested that the Committee of the Ninth Circuit take steps to recommend the elimination of Petitions for Review or Appeals from Orders of the Bankruptcy Judge (Referee) to the District Court. I am satisfied that this would represent the opinion of by far the greatest majority of U.S. District Judges. I can further state from recent

observations that the Judges of the Court of Appeals are appalled at the idea that they would have to sit in judgment and hear almost every appeal from Orders of the Bankruptcy Courts without an Intermediate Court eliminating the most substantial majority of complaints by litigants. It should be noted also that no suggestion was made at the time of the debate at the meeting of the Ninth Circuit Judicial Conference that the original practice on Petitions for Review be heard before a single United States Judge be restored to the new Act as is now the present practice.

It is, therefore, my recommendation that the Resolution finally adopted by the Ninth Circuit Judicial Conference pertaining to Appeals and Reviews except that there be added the word "ad hoc" be adopted. This will require a redrafting of 2–210 by the National Bankruptcy Conference. Except for the provision designating the U.S. Court of Appeals as having jurisdiction over appeals in bankruptcy that the balance of Section 2–210 be adopted, especially the limitations set forth in that draft. Of course, any provision in that draft which would be inconsistent with my argument can also be changed to conform to the idea that the appeal be taken to an Intermediate Appellate Court.

It is an accepted fact that the calendars of the U.S. Court of Appeals are now so congested that without the additions of numerous Circuit Judges or the creation of additional Circuits, the present congested Court Calendars will not be relieved and by adding all appeals from orders and judgments of the Bankruptcy Court, the whole situation will become more aggravated, resulting in greater delay in determining appeals before that Court. Another argument in favor of the Intermediate Court of Appeals is the fact that the Bankruptcy Court is a poor man's Court and by that I do not necessarily mean the individual bankrupt. While a creditor who may have suffered an enormous loss in a large bankruptcy, the amount of net dollars actually recovered may not warrant the expense including attorneys' fees to support an appeal to the Court of Appeals but may warrant an appeal, along with rules setting up a simple procedure, to an Intermediate Appellate Court with an assurance that there will be a prompt decision of the question involved.

The only remaining problem is under what conditions a litigant should have the right to appeal from the Intermediate Appellate Court to the U.S. Court of Appeals? Appeals from the Intermediate Appellate Court could run to the Court of Appeals but be limited to appeals from final orders of substance, or the entire matter of the right to appeal from any judgment of the Intermediate Court of Appeals could be limited to a certiorari or discretionary basis. Limitation on the right to appeal from the Intermediate Court of Appeals should be carefully reviewed again by the various Conferences if the idea of an Intermediate Appellate Court is favorably acceptable to the Congress. I would strongly suggest that the Judicial Conference of the United States be consulted as to their views.

LOS ANGELES, CALIF., FEBRUARY 25, 1976.

MR. ROBERT E. FEIDLER,
Committee on the Judiciary,
U.S. Senate,
Washington, D.C.

DEAR BOB: In connection with the question of appellate proceedings in bankruptcy we have discussed on other occasions, I always advised you that I was opposed to the resolution of the National Bankruptcy Conference that appeals be taken to the Circuit directly from the Bankruptcy Court. This proposal was also, I am informed, endorsed by the American Bar Association, Commercial Bankruptcy Committee, as well as the Bankruptcy Judges Conference.

To further support my proposal for an Intermediate Bankruptcy Court of Appeals or possibly a Bankruptcy Court of Appeals which would be final, with further appeals to go directly to the U.S. Supreme Court, by-passing the Court of Appeals of the Circuit, I now propose the following:

I wish to amend my original recommendation, deleting the proposal that such a Court be "ad hoc." That there be assignment of three or more Judges in each Circuit to this Court, but not on a permanent basis, to be serviced in addition to their other judicial duties in the event that such a Judge is still active and the appointment be for some definite period.

To support my argument that the Courts of Appeals are already so overworked that they cannot handle the case load already existing, I enclose here-

with an article which appeared in the Los Angeles Times on Thursday, February 5, 1976, which is self-explanatory. This argument of Chief Judge Chambers of the Ninth Circuit should convince Congress that we need a different system of appellate procedure that was proposed as above indicated or as now exists (Bankruptcy Judge to U.S. District Judge). I do trust that Congress will give serious consideration to the proposed bankruptcy Appellate Court whether it be intermediate or final.

With kindest and best regards.

Sincerely,

FRANCIS F. QUITTNER,
Attorney at Law.

Enclosure.

HARVARD LAW SCHOOL,
Cambridge, Mass., December 19, 1975.

Senator QUENTIN N. BURDICK,
Chairman, Subcommittee on Improvements in Judicial Machinery, U.S. Senate, Washington, D.C.

DEAR SENATOR BURDICK: Thank you for this opportunity to submit my personal written statement on S. 236. On November 18, 1975, I appeared before your Subcommittee to testify on behalf of the National Bankruptcy Conference. Today I do not write for that or any other organization or institution, but solely to express my own views as one who has taught bankruptcy law for twenty-five years.

While I regard S. 236, as proposed by the Commission on Bankruptcy Laws of the United States, as a vast improvement over the present Bankruptcy Act, all concerned with the subject recognize that there is still room for improvement. I venture to make some suggestions which, as far as I know, have not been made by others appearing before your Subcommittee.

IMPROVIDENT CREDIT EXTENSIONS

In a recent article, *Improvident Credit Extension: A New Legal Concept Aborning?* 27 Me. L. Rev. 1 (1975), copy attached, I have made the argument that many debtors, and their prudent creditors, are victimized by improvident credit extenders and that the Bankruptcy Act should be amended expressly to disallow claims based on improvident credit extensions and to give the trustee a cause of action for damage caused to the debtor or to other creditors by such improvident credit extensions.

If that argument commends itself to the Subcommittee, it could be effectuated by the following amendments to S. 236:

(1) At line 1 of page 7 insert the following new paragraph (27) in § 1–102 and renumber all succeeding paragraphs:

(27) An "improvident credit extension" means a contractual extension of credit to a debtor where it cannot reasonably be expected that the debtor can repay the debt according to the terms of the agreement under which the credit was extended in view of the circumstances of the debtor at the time credit was extended as those circumstances were known to the creditor or would have been revealed to him on reasonable inquiry prior to the credit extension.

(2) At line 15 of page 102, insert the following new paragraph (8) in § 4–403(b) and renumber present paragraph (8) as paragraph (9):

(8) the claim is based on an improvident credit extension; or

(3) At line 14 of page 151 add a new § 4–612:

Sec. 4–612. The trustee shall have and may enforce for the benefit of the estate a case of action for damage caused to the debtor and to his creditors by an improvident credit extension.

TREATMENT OF TAX CLAIMS

While somewhat reducing the number of tax claims entitled to priority, § 4–405(a)(5) of S. 236, at line 15 on page 106, nonetheless provides a priority for a number of tax claims and § 4–506(a)(1)(A), at line 6 on page 123, excerpts from the bankruptcy discharge all tax claims entitled to priority. The Treasury Department may be expected to oppose the reduction in the number of tax claims selected for such favored treatment just as it earlier opposed

the effort which finally succeeded in 1966 to somewhat restrict the favored treatment which had previously extended to *all* tax claims. Presumably, state and local taxing authorities will show no more interest in the subject than they did before and will not appear to testify.

In its previous appearances the Treasury Department has bitterly opposed any proposal to reduce the favored treatment for tax claims, while professing complete inability to calculate the value of the favored treatment to the government fisc. See H. Rept. No. 2535, 85th Cong., 2d Sess., pp. 2, 6–7 (1958); H. Rept. No. 735, 86th Cong., 1st Sess., pp. 2, 6–8 (1959); H. Rept. No. 537, 87th Cong., 1st Sess., p. 2 (1961); S. Rept No 1274, 87th Cong, 2d Sess., pp. 7–9 (1962); H. Rept. No. 372, 88th Cong., 1st Sess., pp. 2, 6–7 (1963); S. Rept. No. 1134, 88th Cong., 2d Session, pp. 6–11 (1964); S. Rept. No. 114, 89th Cong., 1st Sess., pp. 6–7 (1965); H. Rept. No. 687, 89th Cong. 1st Sess., pp. 2, 5–7 (1965); S. Rept. No. 999, 89th Cong., 2d Sess., pp. 11–12 (1966).

But The Brookings Institution study, based on bankruptcy cases closed in 1964 at a time when all tax claims were entitled to priority, found that all tax claimants received \$8.9 million in priority dividends in straight bankruptcy cases in that year and that the federal share of these dividends amounted to \$5.8 million. This sum represented slightly more than 0.005 percent of total federal gross revenues of \$112.3 billion for 1964. But it also represented 11 percent of all the \$51.2 million distributed to all creditors in straight bankruptcy cases in 1964 and almost one-third of the amount paid to unsecured creditors in those cases. D. Stanley and M. Girth, *Bankruptcy: Problem, Process, Reform*, p. 131 (1971). The Bankruptcy Commission also concluded, from more recent data submitted by the Treasury Department, that the total amount collected in bankruptcy cases is "insignificant in the total federal budget." H. Doc. No. 93–137, 93d Cong., 1st Sess., Part I, pp. 22, 216 (1973). Thus, even a full priority contributed only a small drop in the bucket of the federal fisc, but took a very large share of all dividends distributed to creditors in bankruptcy cases.

Of the amount of tax claims not paid in bankruptcy but collected later from the debtor because of the exception from his bankruptcy discharge we know nothing. Only the Treasury Department could supply that information and it has not done so. But we can be certain of one thing. Postbankruptcy tax collections come entirely from individuals. The Treasury Department does not collect taxes from bankrupt corporations.

On this record I submit that no case has been made for *any* preferred treatment for tax claims. The special priority magnifies the damage of bankruptcy to other creditors without making a significant contribution to the federal treasury. The exception from discharge burdens the individual debtor, for whom the discharge is supposed to represent a "fresh start," doubtless again without a significant contribution to the federal treasury which manages to get along without the larger uncollected taxes of bankrupt corporations.

Some may feel that liabilities for withholding taxes—which are included among those marked for favored treatment in S. 236—are in a special category because they were never the debtor's property. But the withheld taxes are always gone by the time of bankruptcy, so that to award the government a priority for withholding tax claims is to compel other creditors to replace the amounts which the debtor has dissipated. And to except such claims from discharge is to use the bankruptcy law for punitive purposes best left to the criminal law.

I urge the Subcommittee to delete § 4–405(a)(5) and § 4–506(a)(1)(A) from the bill.

OTHER EXCEPTIONS TO THE BANKRUPTCY DISCHARGE

The National Bankruptcy Conference has already recommended to you the deletion from § 4-506, at line 24 of page 122 of S. 236, of an exception from the bankruptcy discharge for debts incurred within 90 days of bankruptcy without intent to pay the debt and in contemplation of bankruptcy. The Conference also voted at its October, 1975, annual meeting to recommend deletion of another exception in § 4–506a(8) for certain educational debts. The Conference heard, at that meeting, from a representatives of the Office of Guaranteed Student Loans of the Department of Health, Education, and Welfare, which guarantees most of the student loans and reinsures to the extent of 80% most of the others which are guaranteed by state or nonprofit private organi-

zations. From him we learned that losses under his program due to bankruptcy amount to about 0.5%. This rate compares very favorably with the experience of commercial finance companies on consumer loans and represents no threat to the federal guarantee program. The Conference therefore concluded that there was no basis for an exception to the bankruptcy discharge which would discriminate against education loan debtors.

I agree with both of the recommendations of the Conference, but would go further and urge the Subcommittee to reject the basic notion that exceptions should be carved out of the bankruptcy discharge for the purpose of punishing disapproved conduct—objectives more properly left to the criminal law. The Brookings Institution study found that the typical individual bankrupt (and under § 4–505 a discharge would only be granted to individuals) has a wife and three children, upon whom the Commission's proposals would visit the sins of the father by leaving his future income to a number of debts excepted from the discharge. At a time when many questions have been raised and much study is being devoted to the purpose and efficacy of the sanctions imposed by the criminal law, its seems to me particularly inappropriate to continues our past practice of imposing additional sanctions by restricting the scope of the bankruptcy discharge—a practice which was adopted without, and which has not yet received, any study whatsoever.

If my proposals for deletion of the exceptions for tax claims, 90-day claims, and educational loans were adopted, and if all of the other punitive exceptions were also deleted, there would remain in § 4–506(a) only the exceptions of clause (4) for unscheduled debts, clause (6) for alimony and support, and clause (10) for debts surviving a prior bankruptcy case in which the discharge was waived or denied.

ELIGIBILITY FOR DISCHARGE

Another, and even more extreme, instance of perpetuating the unstudied practice of using the bankruptcy law to supplement the criminal law appears in the grounds for denying a discharge entirely which are specified in § 4–505, at line 14 of page 119 of S. 236. Once again, the sins of the father are to be visited upon the mother and three children, but this time with a vengeance. All relief under the bankruptcy act is to be denied and a windfall is to be conferred on all creditors, whether or not they were in any way affected by the conduct which leads to denial of the discharge.

Here, it seems to me even more imperative that the punitive grounds for denying discharge be deleted. If this were done, there would remain in § 4–505(a) only clauses (3), (4), (5), a limited version of clause (6) dealing with the debtor's conduct in the bankruptcy proceeding, and clause (7) placing a limit on the frequency with which debtors may seek bankruptcy relief.

I have separate difficulties with § 4–505(a)(7) at line 3 of page 121. The Commission's Note points out that the intent was to exclude prior confirmation of either a composition or an extension plan under Chapter VI as a bar to a discharge within the next five years. But at some time after a Chapter VI plan is confirmed most debtors will get a discharge either under § 6–207(a)(1) because they have fully performed the plan or under § 6–207(a)(2) they will get a "hardship discharge" because, even though they have not fully performed, the failure to do so is for reasons for which they should not justly be accountable.

As I read § 4–505(a)(7), any discharge granted under § 6–207(a) would initiate the five-year bar. This raises 3 distinct questions as to whether the five-year bar should apply to:

(1) A discharge granted pursuant to § 6–207(a)(1) to a debtor who has fully performed an extension plan. I would suppose it clearly should not.

(2) To a discharge granted pursuant to § 6–207(a)(1) to a debtor who has fully performed a composition plan. Since the confirmation of such a plan would not initiate the five-year bar, I see no reason why the debtor's full performance of the plan should do so.

(3) To a hardship discharge granted under § 6–207(a)(2) to a debtor who has been unable fully to perform either a composition or an extension plan for reasons for which he cannot justly be held accountable. This is more debatable, but it seems harsh to impose the same penalty on one who has tried and failed under Chapter VI for reasons beyond his control as on one who opted in the first case for a discharge under Chapter V.

I suggest that § 4–505(a)(7) be amended to read: "he was granted a discharge *under Chapter V* or had a plan confirmed under Chapter VII * * *."

THE TRUSTEE'S OMNIBUS AVOIDING POWER

Section 4–604(b)(1), at line 5 on page 138 of the bill, would replace § 70e of the present Act, which authorizes the trustee to avoid any transfer or obligation "which, under any Federal or State law applicable thereto, is fraudulent as against or voidable for any other reason by any creditor of the debtor, having a claim provable under this Act." This provision is now most frequently employed by the trustee to avoid transfers which are perfected at the time of bankruptcy so that they are not vulnerable to the trustee's hypothetical status as a levying creditor as of that time under § 70c [which § 4–604(a) would replace] but which, because of some delay in recording, have become vulnerable to the claims of some creditor or creditors with provable claims.

As so employed by the trustee, § 70e was construed in *Moore* v. *Bay*, 284 U.S. 1 (1931), to mean that (1) the trustee could avoid the entire transfer regardless of the size of the claims of creditors who could have reached the property outside of bankruptcy, and (2) that the trustee's recovery would be for the benefit of all creditors.

The Commission's proposal would overrule *Moore* v. *Bay* entirely by confining the trustee's recovery to the extent of the claims of creditors who could have avoided the transfer outside of bankruptcy and by providing that only such creditors should benefit from the recovery.

The National Bankruptcy Conference agrees that the recovery should be so limited but recommends that it, like the trustee's recoveries under §§ 4–604(a), 4–605, 4–606, 4–607 and 4–608 should be for the benefit of the entire estate. I agree with the Conference's position that the trustee should not be charged with pursuing recoveries merely for the benefit of a few creditors but do not believe that its recommendation goes far enough.

As construed in *Moore* v. *Bay*, § 70e has served a useful function without a substantial burden to those dealing with the debtor. As Congress has recognized at other places in the present Act [§§ 3b, 60a, 67c(1)(b) and 67d(5)], it is desirable to have provisions in a Bankruptcy Act requiring those who take transfers of property from a debtor to disclose that they have done so in order that others dealing with the debtor not be misled and in order that they have an opportunity to discover when he has committed acts of bankruptcy and when he has made transfers which will be voidable when bankruptcy results.

As construed in *Moore* v. *Bay*, § 70e followed the pattern of the other disclosure requirements of the present Act. In each of these instances, Congress might have imposed its own perfection requirements for purposes of the Bankruptcy Act but that would have imposed on transferees a duplicate disclosure requirement—the perfection requirements of the Bankruptcy Act and the perfection requirements of nonbankruptcy law. Instead, in every instance Congress has incorporated the perfection requirements of nonbankruptcy law. Since nonbankruptcy law also provides who may invoke a noncompliance with those laws to invalidate transfers (bona fide purchasers and various types of creditors), Congress in each instance of incorporation has also found it necessary to specify whose rights the trustee can invoke. Section 70e gives him the rights of creditors with provable claims. It incorporates any perfection requirement which nonbankruptcy law may impose for the protection of such creditors.

If Congress had elected to write a separate filing or recording requirement into the Bankruptcy Act, it doubtless would also have written that the consequence of failure to comply would be that the transfer would be voidable by the trustee and that he should recover the property for the benefit of the estate. That is precisely the consequence which *Moore* v. *Bay* attributes to a failure to comply with the incorporated perfection requirements which nonbankruptcy law imposes for the protection of creditors with provable claims.

The Commission's proposed § 4–604(b)(1) would deprive the transferee's failure to comply with perfection requirements of nonbankruptcy law of any significance in bankruptcy—except to impose on the bankruptcy trustee the burden of asserting on behalf of one or a few creditors the rights against the transferred property which they could otherwise assert for themselves.

The National Bankruptcy Conference's proposed amendment, while having the virtue of recognizing that the trustee's efforts should be expended on behalf of the entire estate, unduly burdens his task. Under present § 70e as interpreted in *Moore* v. *Bay*, the trustee need identify only one creditor with a provable claim who could have avoided the transfer in order to avoid it for

the estate. But under the Conference's recommended version of § 4–604(b)(1), where the size of the trustee's recovery would be measured by the claims of creditors who could have avoided the transfer, it behooves the trustee to locate and identify and to prove the amount of the claims of *all* creditors who could have avoided the transfer. In many cases the amount which could be recovered for the estate would not justify the effort.

In one other respect the Commission's proposed § 4–604(b)(1), and the National Bankruptcy Conference's recommended version, would drastically impair present § 70e's function of requiring those who take transfers of the debtor's property to disclose that they have done so as required by perfection requirements of nonbankruptcy law for the protection of creditors with provable claims. Under § 57a of the present Act a secured claim is provable although, under § 57h, it is allowable only to the extent that it exceeds the value of the security. And the few cases to consider the point have held that where nonbankruptcy perfection requirements are imposed only for the protection of lien creditors and not for the protection of unsecured creditors, the trustee under § 70e can nonetheless avoid a transfer for noncompliance with those requirements if he can identify one lien creditor with a provable claim who could have done so. *Abramson* v. *Boedecker*, 379 F.2d 741 (5th Cir.), crt. denied 389 U.S. 1006 (1967); *Electric Constructors, Inc.* v. *Azar*, 405 F. 2d 475 (5th Cir. 1968). See also *Stevan* v. *Union Trust Co.*, 316 F. 2d 687 (D.C. Cir. 1963).

The proposed new Bankruptcy Act abandons the concept of "provable" claims in favor of a concept of "allowable" claims. See § 4–403. Under § 4–402(b) only unsecured claims are to be allowed in Chapter V liquidation cases. Thus, when § 4–604(b)(1) limits the trustee to avoiding transfers which could have been avoided under nonbankruptcy law by creditors "having claims allowable in a Chapter V case" it limits him to avoiding those transfers which an unsecured creditor could avoid.

But under §§ 9–301 and 9–312 of the Uniform Commercial Code, in effect in the District of Columbia and in all states but Louisiana, delay in perfection renders a transfer vulnerable only to secured creditors, not to unsecured creditors. Thus proposed § 4–604(b)(1) would impose virtually no disclosure requirement on those taking transfers of personal property from the debtor. And, since virtually no real estate perfection law protects unsecured creditors who have acquired no interest in the property [IV *American Law & Property* § 17.9 (Casner Ed. 1952)], the proposed section 4–402(b) would impose virtually no disclosure requirement on those taking transfers of real property from the debtor either.

Thus, § 4–604(b)(1), as proposed by the Commission or as revised by the National Bankruptcy Conference, is too trivial in its effect to be worth enacting. But because I believe present § 70e has performed a useful function by requiring those who take transfers from the debtor to disclose that fact, without imposing upon them the burden of a separate perfection requirement, I urge the Subcommittee to revise § 4–604(b)(1) to read:

"Any transfer of the debtor's property and any obligation incurred by the debtor which is voidable by applicable law by any creditor of the debtor is voidable by the trustee for the benefit of the estate."

PREFERENCES

While I believe the basic scheme of the new preference section, § 4–607 at line 19 on page 141 of S. 236, is a sound one, I am troubled by some of the exceptions to its application—one of which is expressly labeled an exception and others of which follow from a definition of the term "antecedent debt."

(1) There is an express exception, at line 15 of page 142, where relatives or insiders are not involved, for transfers of less than $1,000. The National Bankruptcy Conference voted last October to recommend that the amount be reduced to $500. The entire concept seems to me too mechanical. When, year in and year out, nothing is available for distribution to creditors in more than 85% of the straight bankruptcy cases and in about three-fourths of the cases nothing is available for administration expenses either, it seems to me unwise to cast in the statute a rule which says that preferences of less than $500 are not recoverable. This is a matter which should be left to the judgment of the trustee as to whether the issue is worth litigating. Moreover, if this exception

were deleted, there will be many instances where the trustee can recover preferences of less than $500—or a compromised portion thereof—without litigating. There will be no such recoveries if the exception remains in § 4–607.

(2) The definition of "antecedent" debt of line 3 on page 145 includes only debts incurred more than five days before a transfer paying or securing the debt. This again seems to me much too mechanical. It would overrule two Supreme Court cases, both of which seem to me to demonstrate that this matter is much better left to the courts. One, *Dean* v. *Davis*, 242 U.S. 438 (1917), held that where a mortgage was contemplated at the time a loan was made, but was not executed until seven days later, it was not a transfer for antecedent debt but for "a substantially contemporaneous advance." The other, *National City Bank* v. *Hotchkiss*, 231 U.S. 50 (1913), held that when a bank made an unsecured day loan to a broker at 10 a.m. and, on learning shortly thereafter that he was in financial difficulty, demanded and received security between 2 p.m. and 3 p.m. the same day, there was a transfer for antecedent debt.

(3) Antecedent debt is also defined to exclude all debts for personal services. That exception should make all corporate executives of debtor corporations, all lawyers and doctors and plumbers just as happy as it will make wage earners. I can conceive of no justification for this exception in its present form. Nor, if that was the intent, do I believe it necessary for the protection of wage earners in view of the express exception at line 23 of page 142 for transfers which do not enable the creditors benefited to obtain a greater percentage of his claim that other creditors of the same class.

(4) Also excluded from the definition of antecedent debt is a debt for utilities incurred within three months of bankruptcy, thus insulating from the preference section one large class of creditors who are in a strong position to obtain preferential payments from an insolvent debtor through threats to cut off services but leaving another similar class—landlords—a legitimate ground to complain about discrimination. I see no justification for this exception.

(5) Additionally excluded from the definition of antecedent debt are debts for inventory paid for within three months of delivery of the goods in the ordinary course of the debtor's business. Passing the point that it is unclear whether this exception requires that the delivery, the payment, or both be in the ordinary course of the debtor's business, this and the preceding exception now leave landlords, unsecured equipment suppliers, and lenders to inquire why only they are now to be subject to the law about preferential transfers. I do not find the answer to this highly pertinent question either in the Commission's discussion of preferences in its report [H. Doc. No. 93–137, 93d Cong., 1st Sess., Part, I, pp. 201–211 (1973)] or in its Notes to § 4–607.

REORGANIZATIONS

I have four problems with Chapter II of S. 236, which is designed to replace Chapters X (Corporate Reorganizations), XI (Arrangements) and XII (Real Property Arrangements) of the present Act. In increasing order of importance, they are:

(1) Under § 7–101(a), at line 20 on page 182, the administrator is to appoint an official creditor's committee "representative of the different types, if any, having claims against the debtor" which "ordinarily" is to consist of seven persons chosen from creditors holding the largest amount of unsecured claims against the debtor. Under § 7–101(b) the administrator may also appoint additional committees to represent unsecured creditors or stockholders. Under § 4–403(a)(5) such official committees are to be compensated out of the estate for "expense * * * incurred in carrying out [their] duties."

It is also contemplated that, in recognition that these official committees may not adequately represent all interested parties, there may be unofficial committees. (See the Commission's Note 7 to § 7–101.) But under § 4–403(a)(8) such unofficial committees are to be compensated only for "services representing a substantial contribution to a confirmed plan." This eliminates compensation for an unofficial committee not only where it (1) contributes nothing and (2) contributes to a plan which is not confirmed, but also (3) where it successfully contends that no plan should be confirmed. Such discouragement of the opponents of any plan is not the present practice under Chapter X [see present § 242(1)] or under Chapter XI [see Chapter XI Rule 11–29(c)]. It should not be the practice under the new Chapter VII.

(2) Section 7–309(a), at line 11 on page 213, provides that indenture trustees who file proofs of claim may, if authorized to do so, accept plans on behalf of security holders represented by them. Most indenture trustees are not competent to cast a vote for acceptance or rejection of a plan unless they also have an investment of their own in the debtor, in which event they should be disqualified to vote on behalf of security holders under the indenture because of conflict of interest. For this reason, § 198 of the present Act does not permit them to vote for other security holders. At the April, 1975, meeting of the National Bankruptcy Conference, William M. Kahn, Esq., representing New York City banks engaged in the business of acting as indenture trustees, advised the Conference that those banks did not desire to vote on plans on behalf of security holders under the indenture. The authorization for them to do so should be deleted from § 7–309.

(3) Section 264a of present Chapter X provides:

The provisions of section 5 of the Securities Act of 1933 shall not apply to—

(1) any security issued by the receiver, trustee, or debtor in possession pursuant to paragraph (2) of section 116 of this Act; or

(2) any transaction in any security issued pursuant to a plan in exchange for securities of or claims against the debtor or partly in such exchange and partly for cash and/or property, or issued upon exercise of any right to subscribe or conversion privilege so issued, except (a) transactions by an issuer or an underwriter in connection with a distribution otherwise than pursuant to the plan, and (b) transactions by a dealer as to securities constituting the whole or a part of an unsold allotment to or subscription by such dealer as a participant in a distribution of such securities by the issuer or by or through an underwriter otherwise than pursuant to the plan.

Read literally, this section would forever exempt transactions in any security issued pursuant to a plan and the two exceptions in (a) and (b) of clause (2), both of which deal with transactions subject to the issuance under the plan, lend support to that reading. Nonetheless, the SEC has always taken the position that the exemption applies solely to the transaction involved in effecting the initial exchange of securities under the plan. The SEC's position finds support in S. Rept. No. 1916, 75th Cong., 3d Sess., p. 39 (1938) which says that "the exemption for the issuance of securities to security holders and creditors under the plan does not extent to any subsequent redistribution of such securities by the issuer or an underwriter; for any such redistribution is subject to the same need for public disclosure of relevant data as in the case of a new issue. This need for registration upon redistribution has been recognized by the Securities and Exchange Commission in its interpretation of section 77B(h), but the revision embodied in section 264 is designed to remove all doubt as to the correctness of that interpretation."

Section 7–314, at line 4 on page 221 of S. 236, seems to me to preserve, if not to magnify, the ambiguities of present § 264a. I suggest that it be revised to read as follows:

"No provisions of any law requiring registration of securities or registration or licensing of issuers of securities shall apply to a transaction incident to (1) the issuance of any security by the trustee or debtor in a transaction approved by the administrator or the court under this Act; or (2) the issuance of a secrity pursuant to a plan in exchange for securities of the debtor or for allowed claims, or partly in such exchange and partly for cash or property; or (3) the issuance of any security on exercise of any right to subscribe or conversion privilege issued pursuant to a plan."

(4) Under §§ 174 and 221 of present Chapter X of a plan of corporate reorganization cannot be approved or confirmed unless the court finds, among other things, that it is "fair and equitable." This language, carried over from former § 77B, and the same language in present § 77(e), is construed by the Supreme Court to incorporate the "absolute priority" rule under which each class of security holders, in the order of their seniority, must receive full compensation in new securities issued under a plan based on a capitalization of estimated future earnings before a junior class can participate. *Case* v. *Los Angeles Lumber Products Co.*, 308 U.S. 106 (1939); *Consolidated Rock Products Co.* v. *DuBois*, 312 U.S. 510 (1941); *Group of Institutional Investors* v. *Chicago, Milwaukee, St. Paul and Pacific R. Co.*, 318 U.S. 523 (1943).

This test is not a popular one, since it means that whenever, under the valuation of the debtor's enterprise, it is insolvent, the old stockholders are wiped out, the test is not popular with management and other stockholders.

Moreover, the estimation of future earnings and the selection of an appropriate capitalization rate upon which the valuation and the new capital structure are to be based involve matters of judgment and where the judgments have been made no one can be completely confident that the resulting valuation is precisely accurate. Nonetheless, it is the best valuation system anyone has been able to devise and the absolute priority test does preserve the priorities which the various investors in the debtor bargained for at the time of their investment.

The Commission does not profess to come up with a better test or with a better method of valuation. Rather, it proposes to loosen up the valuation process and to carve some exceptions into the absolute priority test by three proposed provisions:

(1) Under § 7–310(d)(2)(B), at line 17 on page 216 of the bill, the "fair and equitable" language on which the absolute priority test is based is surrounded by verbiage requiring the court to find that "there is a reasonable basis for the valuation on which the plan is based and the plan is fair and equitable in that there is a reasonable probability that the securities issued and other consideration distributed under the plan will fully compensate the respective classes of creditors and equity securities holders of the debtor for their respective interests in the debtor or his property."

The best that can be said for this formulation is that the "fair and equitable" standard is now surrounded by weasel words. The Commission's Note 9 to § 7–310 says that "the court is allowed more leeway in arriving at an informed estimate of valuation in recognition of the difficulty of predicting future earnings and arriving at an appropriate capitalization rate." It seems apparent that the Commission's hope was that the court will operate in this leeway to increase the valuation on which the plan is based and thus to increase the participation of junior interests, since its sole criticism of the absolute priority rule is that "publicly held" subordinated debt and stock is frequently eliminated in the reorganization plan. H. Doc. No. 93–137, 93d Cong., 1st Sess., Part I, p. 256 (1973). Of course, this adjustment to save publicly held debt or stock will also save that which is not publicly held.

If the effect of the present "fair and equitable" language, as construed by the Supreme Court, is (and I believe it is) to tell reorganization courts to do the best job they can in estimating future earnings and in selecting an appropriate capitalization rate, the message I get from the Commission's proposal is that the reorganization court need not do the best it can, but should exercise its "leeway" to do a less conscientious job with a view to providing higher valuations. This proposal is not likely to produce more sound and successful reorganizations and I urge the Subcommittee to return to the original "fair and equitable" test without the leeway-providing verbiage.

(2) Section 7–303(3), at line 13 on page 204 of the bill, would permit the plan to provide for delayed contingent participation rights to any class of creditors or stockholders who would be excluded from participation under the valuation on which the plan was based. These rights would be contingent on the court's finding, within five years from the date of confirmation of the plan, "that the reorganized debtor or the successor under the plan has attained a financial status that warrants such participation." This is a "heads I win, tails you lose" proposition which has been rejected under present Chapter X, *Spitzer* v. *Stichman*, 278 F. 2d 402 (2d Cir. 1960). Those who are given stock in the reorganized debtor under the plan are told, in effect, that they have received a very unique type of stock. If the reorganized debtor does not prosper, they bear the loss. If the debtor does prosper, the gain goes to the holders of delayed participation rights. The existence of such contingent rights would have a disastrous effect on the market price of securities issued under the plan and on subsequent efforts of the reorganized debtor to raise new capital. I recommend that § 7–303(3) be deleted.

(3) Under § 7–303(4), at line 24 on page 204, when stockholders do retain an interest under the valuation on which the plan is based, and when they will "make a contribution which is important to the operation of the reorganized debtor," the plan may provide for participation by them, not only to the extent of the value of their old stock, but also on the basis of "the additional estimated value of such contributions." This provision would allow precisely what the Supreme Court refused to allow under Chapter X in *Case* v. *Los Angeles Lumber Co.*, supra.

If this idea had merit, § 7–304(4) is defective on its face, since there is no reason why it should be limited to cases where the old stock had some value. But I believe the idea has no merit. *Case* v. *Los Angeles Lumber Co.* was not a constitutional ruling and it may be overturned by new legislation. But this proposal is merely a new stock watering device since it is still true, as the Court said in *Case*, that the "important contribution" to be made by the old management which managed the debtor into financial difficulty "cannot possibly be translated into money's worth reasonably equivalent to the participation accorded to the old stockholders" and "has no place in the asset column of the balance sheet of the new company." 308 U.S. at 122–123.

If continuation of the old management is considered desirable the reorganized debtor can enter into a contract binding on both parties (§ 7–303(4) does not seem to require any commitment by management to serve) under which they can be compensated for their services—as they would doubtless expect to be even if they were given a special participation under the plan. I also recommend the deletion of § 7–303(4).

I have tried to be as brief as possible in commentary on these proposals to alter the absolute priority rule. If more detailed arguments against these proposals are desired, I commend to the Subcommittee the following: Brudney, *The Bankruptcy Commission's Proposed "Modification" of the Absolute Priority Rule*, 48 Am. Bankr. L.J. 305 (1974); Blum and Kaplan, *The Absolute Priority Doctrine in Corporate Reorganizations*, 41 U. Chi. L. Rev. 651 (1974); Note, *The Proposed Bankruptcy Act: Changes in the Absolute Priority Rule for Corporate Reorganizations*, 87 Harv. L. Rev. 1786 (1974).

Again, Mr. Chairman, I thank you for this opportunity to present my views.

Sincerely yours,

VERN COUNTRYMAN.

INTERNAL REVENUE SERVICE,
DEPARTMENT OF THE TREASURY,
Washington, D.C., May 19, 1976.

Hon. QUENTIN N. BURDICK,
Chairman, Subcommittee on Improvements in Judiciary Machinery, Committee on the Judiciary, U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: In accordance with my statement submitted for the record on November 6, 1975 when I appeared before your Subcommittee, I am enclosing our analysis of the tax aspects of S. 235 and S. 236 (94th Cong., 1st Sess. (1975)).

As I indicated in my testimony before your Subcommittee on November 6, 1975, we have been attempting to gather statistical data pertaining to the collection of federal taxes in bankruptcy cases. The data we have been able to compile thus far is also enclosed. We are endeavoring to obtain more extensive data, which will be furnished your Subcommittee as it is compiled.

The Office of Management and Budget has advised us, through Assistant Secretary Walker's office, that there is no objection from the standpoint of the Administration's program to the submission of our analysis.

Sincerely,

DONALD C. ALEXANDER,
Commissioner.

Enclosure.

ANALYSIS OF THE TAX ASPECTS OF S. 235 AND S. 236, 94TH CONG., 1ST SESS. (1975) AND THE REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. NO. 93–137, 93D CONG., 1ST SESS. (1973)

I. PROCEDURAL TAX PROVISIONS

Section 4–606—Certain Statutory and Common-Law Liens

Under section 4–606(a), every federal tax lien on assets in the bankruptcy estate is invalid. For purposes of section 4–606(a), it does not matter whether a notice of lien was filed before bankruptcy.

Furthermore, the trustee is entitled under section 4–606(b) to recover any property transferred by the debtor, whether solvent or insolvent, within three

months[1] prior to the petition date to satisfy a tax liability secured by a lien invalidated under section 4–606(a). Thus, if a federal tax lien had arisen regarding a tax liability of the debtor, the trustee would thereafter be able to recover under section 4–606(b) not only the amount of any voluntary payment made by the debtor in satisfaction of such liability, but also any property of the debtor seized by the Service to collect the liability. It is not clear whether the trustee would be able to recover the amount received by the Service from the sale of such seized property, nor whether the trustee would be entitled to recover the property from the purchaser thereof. It is also unclear whether the trustee would be able to recover from the Service the amount of an overpayment made by the debtor, which had been setoff under Internal Revenue Code § 6402 during the three-month period prior to bankruptcy.

Section 4–606 is applicable in cases under chapters V (Liquidations: Voluntary and Involuntary Bankruptcies); VI (Plans for Debtors with Regular Income); VII (Reorganizations); and IX (Railroad Reorganizations).

Under present law, if a notice of lien pertaining to a federal tax assessment is filed prior to the filing of a petition in an ordinary bankruptcy proceeding, the federal tax lien is not invalidated and may be claimed as a secured debt against the trustee in his status as a judgment lien creditor under Bankruptcy Act § 70c. Under these circumstances, if any of the bankrupt's property to which the federal tax lien attached is seized by the Service before the petition date, such property does not become part of the bankruptcy estate. If the federal tax lien attached to real property of the bankrupt not seized prior to bankruptcy, the underlying tax liability is entitled to full satisfaction ahead of both priority and general creditors. However, if personal property to which the tax lien attached is not seized before bankruptcy, the underlying liability is subordinated under § 67c(3) to the priorities in § 64a(1) (administration expenses) and § 64a(2) (preferred wage claims).

If a notice of federal tax lien has not been filed prior to bankruptcy, the lien is invalid against the trustee in his judgment lien creditor status. Thus, the underlying tax liability has the status of an unsecured claim, and is entitled to priority under Bankruptcy Act § 64a(4) if it is excepted from discharge under § 17a(1). If such tax liability is dischargeable, it is treated as a general, unsecured claim.

The invalidation of federal tax liens pursuant to Bankruptcy Act § 70c, and their subordination under § 67c(3), do not affect the collection of federal taxes in cases under § 77 (Reorganization of Railroads Engaged in Interstate Commerce), chapter X (Corporate Reorganizations), or chapter XII (Real Property Arrangements). Rather, whether or not a notice of federal tax lien has been filed prior to bankruptcy, no reorganization plan or real property arrangement can be confirmed which does not provide for full payment of all claims for federal taxes (unless a lesser amount is accepted by the Government). In cases under chapters XI (Arrangements) and XIII (Wage Earners' Plans), it does make a difference whether or not a notice of federal tax lien was filed before bankruptcy; secured creditors may not be affected by a chapter XI proceeding, whereas creditors with secured liens against the debtor's personal property may be affected if they accept a chapter XIII plan. Under both chapters XI and XIII, unsecured tax claims entitled to priority under Bankruptcy Act § 64a are required to be paid in full pursuant to a confirmed plan (unless a lesser amount is accepted by the Government).

Discussion

Noting that some statutory liens are "genuine property rights," whereas others are "essentially State-created priorities," Congress in 1966 revised Bankruptcy Act § 67c(1).

Rather than focusing on some of the ambiguities in present Bankruptcy Act § 67c(1), and thereby continuing to distinguish between statutory liens that are true property rights and those that are in reality priorities, the Commission instead concluded that all statutory liens are "disguised priorities." (*Report*, pt. I, 21.) Thus, section 4–606(a) invalidates every statutory lien against the assets of the bankruptcy estate, except those pertaining to the repair or improvement of specific property, ad valorem taxes, special improvement cost assessments, or attorneys' fees.

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[1] Four months under section 4–606(b) of S. 235.

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Federal tax liens for which notices have been filed are in the nature of "genuine property rights," rather than "disguised priorities." They are as much a property right as a mortgage or deed of trust on real property or a security interest under the *Uniform Commercial Code*. The primary distinction is that federal tax liens are nonconsensual. If anything, the Government has a superior equitable claim to that of secured creditors, since it cannot pick and choose its debtors. In 1973 the Service projected that $5,190,758 would be collected in calendar year 1973 on federal tax liens having secured status against trustees in bankruptcy proceedings. (*See Report*, pt. I, 234 n. 228.) The invalidation of federal tax liens in bankruptcy proceedings would thus impose an unfair burden on the Government since eliminating the Government's status as a secured claimant could significantly reduce or eliminate its recovery from the assets of a bankruptcy estate. Also, the invalidation of federal tax liens in bankruptcy proceedings may cause delinquencies to soar. The opportunity for unsecured creditors to eliminate the effects of tax liens for which notices have been filed against the property of debtors may result in a substantial increase in the number of involuntary bankruptcies,[2] and thus the amounts of federal taxes involved therein.

Additionally, under section 4–606(b), any property transferred by the debtor, whether or not voluntarily, within three months before bankruptcy to satisfy a federal tax liability secured by a lien invalidated under section 4–606(a) is unconditionally recoverable by the trustee. All collection efforts by the Service within three months prior to the bankruptcy of a debtor would, therefore, be completely futile if the trustee recovers the amount collected.

Recommendation

Section 4–606(a) would in all probability significantly reduce the collection of federal taxes in bankruptcy proceedings, and may result in an increase in the number of involuntary petitions filed against debtors. More importantly, section 4–606(b) would, in most circumstances, render the tax collection procedures of the Service inoperative during the three-month period preceding bankruptcy. For these reasons, the invalidation of federal tax liens under section 4–606(a), and the recoverability under section 4–606(b) of payments made to or property seized by the Service, are opposed.

We therefore recommend that present clause (2) of section 4–606(a) be changed to read: "(2) which secures a tax imposed by the United States, any state, or any subdivision of any state."

Section 4–607—Preferences

Section 4–607(a)(1) provides that the trustee may recover property of the debtor which was transferred to pay or secure an antecedent debt, if the transfer was made while the debtor was insolvent and within three months[3] prior to bankruptcy. As provided in section 4–607(b)(1), however, the trustee may not avoid such transfer if the aggregate value of all property transferred to a creditor is less than $1,000.[4] Further, section 4–607(b)(3) provides that the trustee may not avoid a transfer which does not enable the benefited creditor, as of the date of the petition, to obtain a greater percentage of his claim than other creditors of the same class, so long as there are no creditors of a higher class who are unpaid. A presumption of insolvency throughout the three-month period[5] preceding bankruptcy is created by section 4–607(f), and section 4–607(g)(1) defines "antecedent debt" as a "debt incurred more than five days [[6]] before a transfer paying or securing the debt."

Thus, any payment made by or property seized from an insolvent debtor within three months prior to bankruptcy to satisfy or secure a federal tax liability more than five days old (whether or not a lien had arisen thereon) would be a recoverable preference under section 4–607(a) if: (1) the amount paid and/or the aggregate value of the seized property were $1,000 or more; and (2) the result of such transfer, measured as of the petition date, enabled the Service to obtain a greater percentage of its claim than other creditors of the same class. It is unclear whether the trustee could recover under section

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[2] Under section 4–205(c), which generally substitutes the equity test of insolvency for an act of bankruptcy, an involuntary petition may be filed if it is shown the debtor "will be generally unable" or "has generally failed" to pay the debts he owes when they become due. Additionally, the requirement of an act of bankruptcy is eliminated, as well as that several creditors join in the petition.

[3] Four months under section 4–607(a)(1) of S. 235.

[4] This provision is not contained in S. 235.

[5] Four-month period under section 4–607(g) of S. 235.

[6] Thirty days under section 4-607(h)(1) of S. 235.

4–607(a) either the amount received by the Service from the sale of such property, or the property itself from its purchaser. It is also not clear whether the pre-bankruptcy setoff under Internal Revenue Code § 6402 of an overpayment made by an insolvent debtor within three months before the petition date would constitute the transfer of property and thus could be recoverable as a preference if the other elements of a preference were in existence. (*See generally Report*, pt. I, 211.)

Section 4–607 is applicable in cases under chapters V (Liquidations); VI (Plans for Debtors with Regular Income); VII (Reorganizations); and IX (Railroad Reorganizations).

Present Bankruptcy Act § 67b provides that federal tax liens, which arise or are filed while the debtor is insolvent and within four months prior to the filing of the bankruptcy petition, are not voidable by the trustee as preferences under § 60. Furthermore, it appears that neither the payment made by an insolvent bankrupt to satisfy his tax liability, the seizure of his property or rights to property, nor the setoff of his tax liability pursuant to Internal Revenue Code § 6402, is considered a preference under § 60.

Bankruptcy Act § 60 applies in proceedings under § 77 (Railroad Reorganizations), chapter X (Corporate Reorganizations), chapter XI (Arrangements), chapter XII (Real Property Arrangements), and chapter XIII (Wage Earners' Plans).

Discussion

Due to the fact section 4–606(b) is applicable to both solvent and insolvent debtors and contains none of the exceptions found in section 4–607(b) (aggregate value requirements, etc.) it appears a trustee would almost always use section 4–606(b) to recover from the Service any payment made by or property seized from a debtor within three months prior to bankruptcy to satisfy a tax liability on which a lien had arisen.

We have assumed that installment payments of estimated income tax by individuals and corporations, as well as federal tax deposits made by employers, would not be recoverable as preferences under 4–607(a) since such a payment or deposit does not pertain to an "antecedent debt" but rather a future tax liability. However, we think the Committee reports should specifically state that section 4–607 does not apply to estimated tax payments and federal tax deposits, so as to avoid future tax litigation.

If we are wrong in this assumption, we would be vehemently opposed to the applicability of section 4–607 to estimated tax payments and federal tax deposits. The recoverability of these remittances as preferences would be extremely disruptive and would have severe adverse consequences to employee-debtors, *e.g.*, the reversal of income, F.I.C.A. and R.R.T.A. withholding tax credits, with the accompanying increases in income tax liability due to such reversal of credits.

Moreover, if section 4–607 is applicable to federal tax deposits, it is probable that a substantial amount of withholding taxes will be recovered by trustees in bankruptcy proceedings. In this regard, it is noted that during fiscal year 1975 the Service collected over $185 billion in income taxes withheld by employers and F.I.C.A. taxes. (*See 1975 COMM'R of INT. REV. ANN. REP.* 14.)

Recommendation

Substantial amounts of money and property may be recoverable from the Service as preferences under section 4–607(a). This would hinder the tax collection procedures of the Service during the three-month period preceding bankruptcy. Thus, the recoverability under section 4–607(a) of property of the debtor used to pay or secure a federal tax liability is opposed.

We therefore recommend that a new subpart (E) be added to section 4–607 (g)(1), to read: "(E) a tax imposed by the United States, any state, or any subdivision of any state."

Section 4–405—Distribution of Proceeds

Section 4-405(a)(1) establishes a first priority for administrative claims allowed under section 4-403(a),[7] which lists the expenses of administration for

[7] S. 236 and *Report*, pt. II, 109, incorrectly refer to section 4–402(a). (Also, an incorrect reference to section 4–402(b) occurs in section 4–405 (a)(7), (8), (9) of S. 236 and *Report*, pt. II, 110.)

which administrative claims are allowable. Although taxes are not specifically mentioned in section 4–403(a), it appears a claim for a post-petition tax incurred during administration would be categorized under section 4–403(a)(5) as an "expense * * * incurred in carrying out his duties by the trustee [or] the administrator." (*See* note 12 to section 4–403. *Report*, pt. II, 103; *see also Report*, pt. 1, 231 n. 210.) Further, it appears that both interest and penalties pertaining to taxes incurred during administration would also constitute administration expenses entitled to priority under section 4–405(a)(1).

Under present law, taxes incurred by the trustee during the bankruptcy proceeding are generally treated as expenses of administration entitled to first priority under Bankruptcy Act § 64a(1), *e.g.*, income, and income withholding and employment taxes (F.I.C.A., R.R.T.A., and F.U.T.A.) on wages earned and paid during the period of administration.[8] Additionally, interest and penalties on taxes incurred during the bankruptcy proceeding are also treated as expenses of administration.

With regard to pre-petition taxes, section 4–405(a)(5)(A) grants priority to incomes taxes for any taxable period ending on or before the petition date, if the due date for filing the return (or the extended due date) is within one year prior to the date of the petition or thereafter. The priority extends to taxs shown on the return filed by the debtor within one year before the petition date or thereafter, as well as to any deficiencies that may later be determined and assessed by the Service (whether before or after the petition is filed).

Under section 4–405(a)(5)(B), priority is given to ad valorem taxes last payable without penalty within one year prior to the date of the petition.

Section 4–405(a)(5)(C) establishes priority for taxes that were withheld from wages paid by the debtor before bankruptcy. Since the one-year time limitation on priority is not applicable to withholding taxes ,section 4–405(a)(5)(C) is in conformity with present law. Additionally. nota 6 to section 4–406. *Report*, pt. II, 116, indicates the 100% penalty imposed by Internal Revenue Code § 6672 qualifies for priority under section 4–405(a)(5)(D) (which, as subsequently discussed, pertains to the employer's share of employment taxes). It is believed, however, that the Commission may have meant to construe the priority for withholding taxes under section 4–405(a)(5)(C) to include the 100% penalty, thus conforming with present law.[9]

With regard to wages earned prior to bankruptcy, section 4–405(a)(5)(D) grants priority to the employer's share of employment taxes based on such wages if the due date for filing the return (or the extended due date) is within one year before the petition date or thereafter. Moreover, section 4–405(c) provides that the employer's share of employment taxes on wage claims paid by the trustee under section 4–405(a)(3) are considered claims within section 4–405(a)(5)(D), *i.e.*, pre-petition taxes. This is contrary to the present position of the Service that the employer's share of employment taxes incurred by a trustee when he pays priority wage claims are administration expenses entitled to priority under § 64a(1) of the Bankruptcy Act.[10]

Section 4–405(a)(5)(E) establishes priority for customs duties and excise taxes imposed on transactions occurring within one year prior to the petition date. However, the due date for the return reporting the liability for such duties and taxes can be after the petition is filed.

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[8] However, as in the case of taxes withheld by the bankrupt prior to bankruptcy, if the trustee segregates taxes withheld from wages earned and paid during the proceeding, and the trust fund is identifiable or traceable, the Government will claim the fund as its own property. Further, the Supreme Court held in *Otte* v. *United States*, 419 U.S. 43 (1974), that income and F.I.C.A. withholding taxes on wages earned prior to bankruptcy and paid by the trustee as wage claims under Bankruptcy Act § 64a(2) are entitled to the same priority as the wage claims themselves. It is the position of the Service that the employer's share of employment taxes pertaining to wage claims paid under § 64a(2) are entitled to priority under § 64a(1) as administration expenses.

[9] *See* Plumb, *The Tax Recommendations of the Commission on the Bankruptcy Laws—Priority and Dischargeability of Tax Claims*. 59 *Cornell L. Rev*. 991, 1032–33 n. 258 (1974).

[10] Section 4–405(c) additionally requires the trustee to deduct the appropriate withholding taxes from wage claims paid under section 4–405(a)(3), fringe benefit claims paid under section 4–405(a)(4), and from any other claims for compensation for personal services. The trustee is also required to remit such taxes to the Service. Although not explicitly stated in section 4–405(c), in effect any taxes thus withheld from priority claims for personal earnings paid by the trustee are accorded the same priority as the claims themselves. (*See* note 11 to section 4–405. *Report*, p. II, 114.) Section 4–405(c) conforms in this regard with *Otte* v. *United States*, 419 U.S. 43 (1974).

Further, if an extension of time for payment was granted regarding taxes not included in section 4–405(a)(5) (A)–(E), section 4–405(a)(5)(F) establishes priority for any installments payable within one year prior to the petition date or thereafter. It appears the reference in section 4–405(a)(5)(F) to "taxes which are not included in [section 4–405(a)(5) (A)–(E)] inclusive" pertains to taxes within the enumerated types which are not granted priority, *e.g.*, incomes taxes for which a return was required to be filed more than one year prior to bankruptcy. Such reference, however, could pertain to taxes not within the types enumerated, *e.g.*, estate and gift taxes. Additionally, though it appears that "taxes * * * for which an extension of time for payment was granted" refers to an extension of time for payment under, *e.g.*, Internal Revenue Code § 6161, it is not clear whether section 4–405(a)(5)(F) also refers to a collateral agreement entered into as a condition to the acceptance of an offer in compromise (*see* Treas. Reg. § 301.7222–1(d)(3)), or to a part-payment agreement (*see* Treas. Reg. § 301.6343-1(a)(2)(v)).

Although not expressly stated in S. 236, apparently the pre-petition interest on a pre-petition tax granted priority under section 4–405(a)(5) is entitled to the same priority as the tax itself.[11]

Also, section 4–405(f) provides that partnership creditors share in the distribution of the proceeds of a general partner's individual estate on an equal basis with the individual creditors of such partner.

The priorities established in section 4–405(a) (1)–(5) are applicable to cases under chapters V (Liquidations),[12] VI (Plans for Debtors with Regular Income);[13] VII (Reorganizations);[14] and IX (Railroad Reorganization).[15]

Although the Commission recommended (*Report*, pt. I, 219) that in reorganizations "the priority claims be paid in cash as soon as possible after confirmation and that their payment be assured by the requirement of a deposit of sufficient funds to do so," section 7–303(2) (section 7–301(2) of S. 235) indicates that a plan of reorganization cannot be confirmed unless it provides for either the payment or the securing of the priority claims specified in section 4–405(a) (1)–(5). Thus, priority creditors (including the Government) may have to accept debt and/or equity securities in satisfaction of their claims. In effect, this would be a postponement of payment with some uncertainty of ultimate realization.[16] Additionally, section 7–310(a) (section 7–308(a) of S. 235) provides for the pre-confirmation deposit of "sufficient money to make all payments required to be made in cash pursuant to the plan or the provisions of [chapter VII]." (*See* note 2 to section 7–310, *Report*, pt. II, 253.)

Under present law, federal tax claims in bankruptcy are divided into three categories: (1) lien (secured) claims; (2) priority (unsecured) claims; and (3) general (unsecured) claims.

If no notice of federal tax lien was filed prior to bankruptcy, pre-petition taxes incurred by the bankrupt and excepted from discharge under Bankruptcy Act § 17a(1) are entitled to a fourth priority under § 64a(4).[17]

The general rule under Bankruptcy Act § 17a(1) is that taxes which became legally due and owing more than three years preceding bankruptcy are dis-

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[11] Post-petition interest on claims for pre-petition taxes allowed under section 4–403(b) is entitled to payment pursuant to section 4–405(a)(8) only after all general creditor claims are paid. As subsequently discussed, this priority conforms to present law, whereby post-petition interest on pre-petition claims may be allowed out of bankruptcy estate assets if there is a surplus remaining after the entire principal of all allowed claims has been paid. Additionally, pre-petition nonpecuniary loss penalties are subordinated under section 4–406(a)(3) to all other claims allowed and not subordinated. In turn, section 4–405(a)(9) establishes a ninth (and last) priority for claims allowed under section 4–403(b) and subordinated in payment.

[12] *See generally Report*, pt. I, 214–18.

[13] Pursuant to section 6–206(a)(1)(D) (section 6–402(a)(1)(D) of S. 235), priority claims under section 4–405(a) must be paid in full in advance of or simultaneously with the first dividend payment to creditors under the plan.

[14] *See* section 7–303(2) (section 7–301(2) of S. 235). In addition, S. 235 contains a separate chapter VIII pertaining to arrangements; section 8–304(a) requires the pre-confirmation deposit of money to pay all administration costs and priority debts not part of the plan.

[15] Section 9–101 (section 10–101 of S. 235) indicates section 4–405 applies in railroad reorganization cases.

[16] Section 9–503(d)(3) (section 10–503(d)(3) of S. 235) requires that a plan of railroad reorganization provide "for payment of all amounts required pursuant to section 7–302(2)."

[17] The present priority under Bankruptcy Act § 64a(5) for federal nontax claims is eliminated under section 4–405(a); rather, such claims would be entitled to pro rata payment with other general, unsecured claims. (*See Report*, pt. I, 217–18.)

chargeable. (It is the position of the Service that a tax becomes "legally due and owing" on the last date for the timely filing of a return.) Five exceptions to this rule are provided in § 17a (1) :

(a) Taxes not assessed prior to bankruptcy because a bankrupt failed to make a timely return required by law;

(b) Taxes assessed within one year preceding bankruptcy even though the bankrupt failed to make a timely return required by law;

(c) Taxes which were not reported on a timely return made by the bankrupt and which were not assessed prior to bankruptcy by reason of a prohibition on assessment pending the exhaustion of administrative or judicial remedies available to the bankrupt;

(d) Taxes with respect to which the bankrupt made a false or fraudulent return, or willfully attempted in any manner to evade or defeat; and

(e) Taxes which the bankrupt has collected or withheld from others as required by law, but has not paid over. This exception applies generally to income, F.I.C.A. and R.R.T.A. withholdings. It includes the 100% penalty imposed by Internal Revenue Code § 6672. (If, however, the bankrupt had prior to bankruptcy segregated the withheld taxes and the special trust fund thereby created is identifiable or traceable, the Government will claim the fund as its own property, free of the bankruptcy estate, pursuant to Internal Revenue Code § 7501 (a).)

Income withholding and employment taxes are divisible as of the date of bankruptcy. Therefore, such taxes on wages paid prior to bankruptcy are entitled to priority under Bankruptcy Act § 64a (4). Furthermore, pre-petition interest on a pre-petition tax entitled to priority under § 64a (4) is likewise entitled to such priority.[18]

Additionally, with regard to the debts of partnerships and general partners, Bankruptcy Act § 5g provides in part that "[t]he net proceeds of the partnership property shall be appropriated to the payment of the partnership debts and the net proceeds of the individual estate of each general partner to the payment of his individual debts."

The priority provisions of Bankruptcy Act § 64a are applicable to cases under chapters XI (Arrangements)[19] and XIII (Wage Earners' Plans);[20] however, under § 77 (Railroad Reorganizations), chapter X (Corporate Reorganizations) and chapter XII (Real Property Arrangements), no plan can be confirmed which does not provide for full payment of all claims for federal taxes (unless a lesser amount is accepted by the Government).[21] This absolute priority for federal taxes is eliminated under sections 7–303(2) and 9–503(d)(3) of S. 236. (*See* note 4 to section 7–303, *Report*, pt. II, 244; *see also Report*, pt. I, 218–19.)

Discussion

Based on projections made by the Service for the amounts collected by the Service during 1973 in all bankruptcy proceedings, as well as out of exempt property and property abandoned by the trustee (approximately $46 million),[22] the Commission concluded that:

"[T]he total amount collected by the Federal Government as a result of all of its liens and priorities in bankruptcy proceedings is insignificant in the total federal budget. It is the view of the Commission that it is unseemly for the Federal Government to insist upon collecting its taxes at the expense of other creditors of the taxpayer, and that the only possible justification for this would be a plea of necessity in order to keep the government functioning. As indicated above, such a plea would be totally without foundation in fact." [*Report*, pt. I, 22]

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[18] Neither post-petition interest on pre-petition taxes, nor pre-petition nonpecuniary loss penalties, is claimed against the estate of a bankrupt in proceedings under the Bankruptcy Act unless the bankrupt ultimately proves to be solvent. Rev. Rul. 68–574, 1968–2 C.B. 595.

[19] Under Bankruptcy Act § 361, no plan may be confirmed unless the deposit required by the plan has been made by the debtor. Bankruptcy Rule 11–38(a) requires the debtor, after the plan has been accepted and before confirmation, to deposit the money necessary to pay all priority claims under § 64a of the Bankruptcy Act unless otherwise agreed upon by all the priority claimants. Thus, all priority tax claims must be paid in full upon confirmation, unless a previous agreement was made by the Service.

[20] Bankruptcy Rule 13–309(a)(1)(F) requires that prior to or at the time of payment of the first dividend to creditors under the wage earner's plan, all priority claims under Bankruptcy Act § 64a must be paid out of the money paid in, by or for the debtor, after confirmation of the plan.

[21] *See*, respectively, Bankruptcy Act §§ 77(e), 199 and 455.

[22] *See Report*, pt. I, 234 n. 228.

Using similar logic, the amount paid secured creditors ($46,454,102 or 29.4% of the total proceeds realized in asset cases)[23] during fiscal year 1974 is even more insignificant in terms of the amount of secured indebtedness in the United States.[24] The amount paid unsecured creditors ($44,026,263 or 27.9% of the total proceeds realized in asset cases) during fiscal year 1974 is also insignificant when compared to the total unsecured credit.[25]

But, at least these private creditors are consensual and can choose their debtors, while the Service is a nonconsensual creditor. It appears the Commission has failed to take into consideration the methods for collection available to private creditors vis-a-vis the Government. A private creditor is a consensual creditor and can demand payment in cash by refusing to extend credit. The Government, however, as a nonconsensual creditor does not have this option.

Additionally, in the case of private creditors, losses resulting from debts discharged in bankruptcy are made up in part by charging higher prices to cash sale customers. Some of the losses are also recovered in the form of higher credit charges. D. Stanley & M. Girth, *Bankruptcy: Problem, Process, Reform* 37 (Brookings Institution 1971). More significantly, private creditors receive tax advantages in the form of deductions for bad debt losses, whereas in contrast the Government would in all probability have to raise taxes to absorb the loss of revenue anticipated if S. 236 or S. 235 is enacted.

The Commission considered the rehabilitation of the debtor and the satisfaction of his private debts to be paramount to the collection of federal taxes in bankruptcy proceedings:

"The bankruptcy process affects different creditors to different degrees. A single holder of a large number of claims, such as a taxing authority, is unlikely to be affected substantially by the bankruptcy process because only a minute percentage of almost any population of debtors obtains relief under the Act. However, a creditor with a single claim may be substantially and adversely affected by the nonpayment of the claim because of the debtor's discharge under bankruptcy legislation. Consequently, each creditor's net burden should be weighed against the burden of excepting the debt from discharge.

"Under this standard, the advantages of the position enjoyed by tax debts should generally be reduced in bankruptcy because, notwithstanding the high status of governmental claims in political policy, the burden of relatively small loss to governments is outweighed by both the goal of a fresh start for the debtor and the individual claims of private creditors." [*Report*, pt. I, 78–79]

Moreover, it appears the Commission, in measuring the "net burden" of the "relatively small loss" to the Government resulting from a reduction in the priorities for taxes, failed to focus on the far more serious likelihood of tax avoidance under S. 236.

The idea of comparing tax collections to the total federal budget, if accepted, could easily lead to the reduction of federal tax lien priorities outside of bankruptcy. It was not until the Federal Tax Lien Act of 1966 that Congress substantially conformed the internal revenue laws to commercial practice. If the concept is adopted, however, any secured or unsecured claim could be given priority over a federal tax lien under the same rationale. Similarly, the absolute priority rule of 31 U.S.C. § 191 would be completely reversed.

Under section 4–405(a)(5)(A), priority is granted to income taxes for any taxable period ending on or before the date the bankruptcy petition is filed, if the due date for filing the required return (or the extended due date) is within on year prior to the petition date or thereafter. With regard to income taxes for earlier taxable years, it appears the Government is not entitled to priority unless, as provided in section 4–405(a)(5)(F), an extension of time for payment was granted. Therefore, unless section 4–405(a)(5)(F) is applicable, the Government is denied priority for any income tax for which a return was required to be filed more than one year before bankruptcy, even though delay

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[23] *Tables of Bankruptcy Statistics,* Table F 5 (Administrative Office of the United States Courts, 1975).

[24] The mortgage debt outstanding at the end of 1974 alone was $686,964,000,000 (*Federal Reserve Bulletin* A 44 (March 1975)). Individual secured indebtedness has been estimated by the Federal Reserve Board to be $182,000,000,000 as of April 30, 1975.

[25] The total individual installment credit (excluding automobile, paper and home improvement loans which are generally secured) and noninstallment credit at the end of 1974 was $130,270,000,000 (*Federal Reserve Bulletin* A 47 (March 1975)).

in assessment or collection was justified.[26] Priority is denied such tax, whether the tax was assessed as a result of a return filed showing a balance due or as a deficiency. Priority is also denied even though the tax was not assessed due to the debtor: (1) failing to file a timely return; (2) making a false or fraudulent return, or willfully attempting in any manner to evade or defeat the tax; or (3) nonfraudulently understating tax liability on his return (with assessment being prohibited pending exhaustion of administrative or judicial remedies).

The Commission thus not only reduced the present priority under Bankruptcy Act § 64a(4) for taxes accruing within three years of bankruptcy to taxes accruing within one year of bankruptcy, but it also abandoned the priority presently accorded the Government under § 64a(4) for taxes more than three years old which are exempted from discharge under § 17a(1) due to justifiable delay in assessment and collection because the taxpayer is contesting a proposed deficiency.

As subsequently discussed, section 4–506(a)(1)(A) provides that a discharge extinguishes an individual debtor's liability for any tax denied priority under section 4–405(a)(5). Therefore, a taxpayer who nonfraudulently understates his liability for an income tax can completely avoid payment by filing a voluntary petition in bankruptcy while exercising his appeal rights within the Service and the Tax Court if necessary.[27]

Providing a taxpayer with this opportunity for complete tax avoidance will, in all probability, undermine the effectiveness of the self-assessment system. Further, in view of the significant increase in the number of voluntary bankruptcies within the past year, it would seem unwise to provide taxpayers who are potential bankrupts with the additional incentive of avoiding payment of their tax liabilities.

It is apparent that the successfulness of the self-assessment system of federal taxation in the United States and voluntary compliance depends to a large extent on public confidence in the equity of the tax laws and the evenhandedness and efficiency in which the public perceives the laws to be administered. If S. 236 or S. 235 is enacted, it will not take taxpayers long to see that they can avoid completely the payment of tax deficiencies solely by exercising their appeal rights within the Service and by then filing a petition in the Tax Court if the one-year period has not yet expired. Even if a balance due return is filed, it is unlikely that in most cases the tax can be collected within the one-year period. This undoubtedly will result in more taxpayers taking questionable deductions; lead to a far greater number and dollar amount of delinquent accounts which in fiscal year 1975 was already $5.1 billion; significantly increase the number of bankruptcies which in fiscal year 1975 was 254,484, and as a result, undermine the very roots of the self-assessment system.

The reduction of the present three-year limitation on priority and nondischargeability to one year would place unrealistic burdens on the Service in collecting non-priority taxes prior to bankruptcy. In fact, the Comptroller General recommended that the Bankruptcy Act be amended to have the three-year period run from the date of assessment because the Service has little or no time to collect the tax before bankruptcy. (*Comp. Gen., Report to Joint Comm. on Int. Rev. Tax., Collection of Taxpayers' Delinquent Accounts by IRS* (Aug. 9, 1973) (Dept. Treas. B–137762).) As of the close of fiscal year 1975, the TDA inventory over 1 year old was $398,183,000. (*IRDS Box Score Analysis.*)

As previously mentioned, any taxpayer can completely avoid the payment of any proposed deficiency for a return due more than one year preceding bankruptcy by exercising his appeal rights. This will be so, even though a proposed deficiency was asserted on the day the return was filed. However, it of course takes time to process and audit returns. In fact, the audit cycle for the examination and disposition of income tax returns is 26 months in the case of indi-

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[26] The same one-year rule of priority is applicable under section 4–405(a)(5)(D) to the employer''s share of employment taxes. As under present law, there is no time limitation regarding the priority for withholding taxes (section 4–405(a)(5)(C)). Unlike present law, however, section 4–405(a)(5) does not establish priority for estate and gift taxes.

[27] Furthermore, as provided in section 4–505(a)(7), an individual debtor can be granted a discharge as often as he is able to demonstrate that his inability to pay debts is the result of causes not reasonably within his control, and that payment of such debts from his future income will impose undue hardship.

viduals and 27 months in the case of corporations.[28] Thus, of necessity in most cases, deficiencies will not have even been determined by the Service as of the date of bankruptcy, let alone assessed and collected.

Even in the case of returns filed where the taxpayer admits a balance is due but fails to enclose payment, it is likely that the tax will not be collected within the one-year period. Presently, notwithstanding the highly computerized operations of the Service, it takes approximately five months for a Taxpayer Delinquent Account to be issued, let alone to be collected. Since the trustee can generally recover payments made to the Service within three months prior to bankruptcy, this leaves four months for collection. This is not sufficient time to collect the taxes since the Revenue Officer must first get to the TDA, let alone find assets for seizure if necessary.

Even a jeopardy assessment will not be an effective method for collecting a non-priority tax deficiency since the Service is prohibited from selling any property seized for the collection of the tax pending the Tax Court decision. (*See* Internal Revenue Code § 6863(b)(3).)

Under section 4–405(a)(5)(F), if an extension of time for payment of taxes was granted by the Service, a priority is established for any installments not yet payable on the petition date or payable within one year prior thereto. It therefore appears section 4–405(a)(5)(F) would discourage the use of collateral and part-payment agreements, as well as extension of time for payment agreements, since taxpayers will refrain from entering into such agreements if they are considering bankruptcy as a device to defeat the collection of non-priority taxes.

Hence, the conclusion of the Commission that "[t]he recommended tax priority provisions give the Treasury adequate time to collect taxes" (*Report*, pt. I, 216) is not supportable and is misleading.

Moreover, the general one-year limitation for priority and nondischargeability under sections 4–405(a)(5) and 4–506(a)(1)(A) is inconsistent with the bankruptcy law in many major commercial countries.

In Great Britain, certain debts of a bankrupt are accorded preferential treatment. These preferential debts rank equally among themselves and must be paid prior to the payment of all other debts except expenses of administration, which have first priority. The preferential debts include all taxes assessed against the bankrupt up to the 5th of April next preceding the date of bankruptcy, though this sum may not exceed one year's assessment. The Crown may, however, choose any year; it is not limited to the year of assessment immediately preceding bankruptcy. Further, the Crown may select different years for different taxes. Social security taxes for amounts withheld from pay of employees for the twelve months preceding bankruptcy are also preferential debts, as are land drainage rates and certain wage claims. Generally speaking, preferential tax debts will always be paid in full before the bankrupt is granted a discharge. However, a discharge does not release the bankrupt from any tax debt with which he may be chargeable at the suit of the Crown, unless the Treasury certifies in writing its consent to the bankrupt being so discharged. (*See generally* Lord Hailsham, 3 *Halsbury's Laws of England*, 420–79 (4th ed. 1973).)

In Australia, assessed income taxes are entitled to a tenth priority, which may not exceed the amount of one year's assessment. (Under Australian law, the assessment is nearly identical to the statutory notice of deficiency under Internal Revenue Code § 6212.) Further, the priority may relate to the income tax of any year, where more than one year's assessment is outstanding; it need not relate to the year immediately preceding bankruptcy. Claims for income taxes exceeding one year's assessment are treated as ordinary unpreferred claims. If there are insufficient funds to pay all unpreferred claims after all preferred claims have been paid in full, the unpreferred claims abate in equal proportions. Since the bankrupt is discharged automatically by operation of

[28] Internal Revenue Policy P–4–22 (Approved Feb. 23, 1974). (*See also* I.R. Manual 4112 and 4211.1.) These cycles contemplate the completion of the examination and other processing, including deficiency determinations, by district or service center Audit Divisions. Additionally, Internal Revenue Policy P–4–4 (Approved Feb. 2, 1961) provides that the employment tax returns of a business taxpayer are examined at the same time his income tax return is examined and for the same period. Personnel from the Audit Division have indicated that no statistical data exists pertaining to average completion time for the examination and disposition of income tax returns within each audit cycle.

law five years after the due date of bankruptcy, he will be discharged from all unpreferred tax claims not paid during the proceeding, unless he was guilty of fraud regarding such liabilities. (*See generally* F. Boch and E. Mannix, *Australian Income Tax Guide*, 604–22 (17th ed. 1972).)

In Canada, all tax claims of the Crown are included in the tenth priority granted in bankruptcy. Although within the lowest priority of preferred claims, these tax claims rank ahead of trade and other unsecured creditors. All priority claims, including taxes due to the Crown, must be paid before the bankrupt is granted an unconditional discharge.

In West Germany, taxes payable during the year preceding bankruptcy are entitled to a second priority, whereas all other taxes are granted the sixth, and last, priority. A bankrupt, however, is not discharged after bankruptcy proceedings have been terminated. Therefore, the bankrupt remains personally liable for any tax claims not satisfied during the bankruptcy proceeding.

In France, all direct and indirect taxes due the State within two years of of bankruptcy are granted a priority over all other preferential claims in bankruptcy, except those relating to legal costs. A bankrupt, however, retains the legal obligation to pay all his debts which were not satisfied during the bankruptcy proceeding.

In Belgium, direct income taxes due the Public Treasurer within two years of bankruptcy are given a twelfth priority. The bankrupt remains personally liable, however, for any tax claim not satisfied in bankruptcy.[29]

Recommendation

In summary, it appears the general one-year limitation in S. 236 for the priority and nondischargeability of taxes would have several severe adverse consequences for the Government: (1) the collection of taxes in bankruptcy proceedings would probably be significantly reduced; (2) many individuals could easily avoid payment of pre-bankruptcy taxes by nonfraudulently understating tax liabilities on their returns and filing a voluntary petition in bankruptcy while administratively or judicially contesting such liabilities; (3) the morale of our voluntary self-assessment tax system would be undermined by such means of tax avoidance; and (4) the determination and collection of taxes by the Service prior to bankruptcy would be severely restricted due to the inadequate time allowed.

In our opinion, both the desirability of rehabilitating a bankrupt and the interests of his general creditors must be balanced against these adverse effects to the Government.

Therefore, we are strongly opposed to the one-year priority limitations in section 4–405(a)(5) (A), (B), (D) and (E) and the interrelated one-year nondischargeability limitation in section 4–506(a)(1)(A).

Additionally, the ability of the majority of creditors in corporate reorganization cases (and of the district court in railroad reorganization cases) to force on the priority creditors (including the Government) the acceptance of securities for satisfaction of their claims is objectionable, since this would represent a postponement of payment with some uncertainty of ultimate realization. Hence, the use of securities under sections 7–303(2) and 9–503(d) to satisfy priority claims is opposed.

In the previously referred to report by the Comptroller General to the Joint Committee on Internal Revenue Taxation, it was concluded that:

The Bankruptcy Act, as amended in 1966, gives certain preferences to the Federal, State and local governments not given other creditors by providing that taxes must be "due and owing" more than 3 years before they are eligible for discharge through bankruptcy. However, the determination by IRS and the courts that the 3-year period starts on the due date for filing a return rather than from the date of assessment substantially reduces the time that IRS has to collect the taxes. This time is further reduced if the taxpayer takes advantage of various appeal rights within IRS and the courts. As a result, IRS in some cases has little or no time to collect the tax before the taxpayer files a

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[29] The discussion of priority and dischargeability of taxes in Great Britain and West Germany is based primarily on Ross, *European Bankruptcy Laws* (ABA Press 1974). The discussion regarding France and Belgium is derived from two unpublished reports prepared at the request of the Service by the Library of Congress: T. Cayton, *Enforcement of Tax Claims Against Debtors in Bankruptcy in France* (European Law Division, Law Library—May 1975); V. Stoicoiu, *Enforcement of Tax Claims Against Debtors in*

petition in bankruptcy. To make the preference given the Federal, State, and local governments more meaningful, we believe that IRS and other taxing authorities should have 3 years from the date of assessment in which to collect the taxes before the taxes can be discharged through bankruptcy. [at 29]

Based on this conclusion, the Comptroller General recommended (at 29) "that the Joint Committee on Internal Revenue Taxation initiate legislation to amend the Bankruptcy Act to exclude, from discharge through bankruptcy, taxes assessed within 3 years before a bankruptcy petition is filed."

It is therefore recommended that the one-year priority period in section 4–405(a)(5) (A), (B), (D) and (E) be changed to the three-year period from the date of assessment of the tax, and that section 4–405(a)(5)(A) also be changed to include priority for estate and gift taxes. The taxes granted priority under these changes would be excepted from discharge under section 4–506 (a)(1)(A).

Further, it is recommended that: (1) section 4–405(a)(5)(C) be clarified to indicate the priority for "taxes withheld from wages" includes the 100% penalty imposed by Internal Revenue Code § 6672; (2) section 4–405(a)(5)(F) be clarified to indicate the priority for "taxes which are not included in [section 4–405(a)(5) (A)–(E)] inclusive and for which an extension of time for payment was granted" includes any tax (regardless of the type) for which the Service deferred the payment thereof (*e.g.*, taxes covered by collateral and part-payment agreements); and (3) the method of satisfying priority debts under sections 7–303(2) and 9–503(d)(3) be restricted to cash payments only.

Section 4–506—Exceptions from Discharge; Determination of Dischargeability and Liability on Nondischargeable Debt

Section 4–506(a)(1) provides that the discharge of an individual debtor[30] does not extinguish any tax liability for which: (A) a priority is granted under section 4–405(a)(5); (B) a required tax return was not filed more than one year before the petition date; or (C) a false or fraudulent return was made by the debtor, or the debtor willfully attempted in any manner to evade or defeat.[31]

The dischargeability provisions of section 4–506(a)(1) are applicable to cases under chapter V (Liquidations); VI (Plans for Debtors with Regular Income):[32] and VII (Reorganizations).[33]

Present Bankruptcy Act § 17a(1) provides in effect that a discharge in bankruptcy does not release a bankrupt from the tax debts enumerated therein. As previously discussed, taxes not having a lien status, which are excepted from discharge by § 17a(1), are entitled to a fourth priority under § 64a(4).

Bankruptcy Act § 17a(1) also provides in effect that the discharge of a bankrupt is not a bar to the collection of a dischargeable tax from the bankrupt's exempt property, if any. Furthermore, § 17a(1) states that a discharge "shall not release or affect any tax lien." This lien-preservation proviso clarifies that the denial of priority for dischargeable taxes does not affect the collectibility of such taxes from the bankruptcy estate as a secured claim, if the tax lien (notice of which was filed prior to the petition date) is valid in bankruptcy and not postponed. After-acquired property of a bankrupt, however, cannot be subjected to any pre-bankruptcy tax lien if the underlying tax liability was discharged in bankruptcy.

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[30] Note 3 to section 4–505, *Report*, pt. II, 134, states in part that "[c]orporate debtors are not entitled to discharge under the proposed Act. By dissolution a corporation can obtain relief from all debts."

[31] As under the present judicial rule, both post-petition interest and pre-petition nonpecuniary loss penalties on a nondischargeable pre-petition tax are also nondischargeable, and may be collected from the after-acquired property of the debtor. (*See* notes 4 and 18–20 to section 4–506, *Report*, pt. II, 138, 141.)

[32] Section 6–207(b) (section 6–501(b) of S. 235) provides in part that a discharge granted pursuant to section 6–207(a) (section 6–501(a) of S. 235) does not extinguish the liability of the debtor for debts excepted from discharge by section 4–506(a).

[33] Section 7–311(c) (section 7–309(c) of S. 235) provides in part that confirmation of a plan of reorganization in a chapter VII proceeding extinguishes all claims against the debtor, other than those for debts excepted from discharge under section 4–506. Thus, if the debtor is an individual, tax claims not dischargeable under section 4–506(a)(1) are not discharged by confirmation of the plan. A corporation in a reorganization case in effect obtains a discharge to the extent the plan binds its creditors to satisfaction of less than the total amounts of their claims. (*See* note 3 to section 4–505, *Report*, pt. II, 134.)

Taxes that are not discharged survive the bankruptcy proceeding and are collectible from the after-acquired property of the bankrupt.[34] This also applies to nondischargeable taxes which could have been claimed and paid in the proceeding.

The discharge provisions of Bankruptcy Act § 17a (1) are applicable to cases under chapters XI (Arrangements)[35], XII (Real Property Arrangements)[36], and XIII (Wage Earners' Plans).[37]

In addition, Bankruptcy Act § 77(f) provides in pertinent part that upon confirmation of a plan of railroad reorganization, the provisions of the plan and of the order of confirmation are binding on all creditors. Further, the property dealt with by the plan becomes free of all creditors' claims and the debtor is discharged from its debts, except those which are reserved in the order confirming the plan or directing the transfer or retention of such property.

Moreover, Bankruptcy Act § 228(1) provides that upon consummation of a plan of reorganization under chapter X, a final decree is entered which discharges the debtor from all its debts and liabilities, except as provided in the plan. Thus, the debtor is discharged from any taxes waived by the Secretary of the Treasury, as well as penalties and post-petition interest not recoverable in the proceeding.

Discussion

The earlier discussion of the priority regarding federal taxes under S. 236 is also applicable to dischargeability, since taxes granted priority under section 4–405(a)(5) are excepted from discharge under section 4–506(a)(1)(A).

Section 4–506(a)(1)(B) excepts from discharge taxes for which "a return, if required to be filed, was not filed more than one year prior to the date of the petition." This exception is narrower than present Bankruptcy Act § 17a(1)(b), which excepts from discharge only taxes assessed more than one year preceding bankruptcy, when the bankrupt has not made a timely return.

Additionally, the language in section 4–506(a)(1)(C) ("made a false or fraudulent return or willfully attempted in any manner to evade or defeat") is identical to that in present Bankruptcy Act § 17a(1)(d).

Recommendation

As previously discussed, it is suggested that the general one-year priority period in section 4–405(a)(5) be changed to the three-year period from the date of assessment of the tax. If this change is not made, it is recommended

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[34] In *Bruning* v. *United States*, 376 U.S. 358 (1964), the Supreme Court held that post-petition interest on an unpaid pre-petition tax debt not discharged by Bankruptcy Act § 17 remains, after bankruptcy, the debtor's personal liability which the Government is entitled to recover out of his after-acquired assets. Accordingly, it is the position of the Service that the collection of post-petition interest, whether or not secured by a federal tax lien, will be enforced against after-acquired property of the debtor, if the underlying tax liability is not discharged in bankruptcy. The collection of such interest will also be enforced against income produced from property held as collateral, and against any assets not under the control of the bankruptcy court. Rev. Rul. 68–574, 1968–2 C.B. 595; Treas. Reg. § 301.6871(a)–(2)(a). It is a so the position of the Service that pre-petition nonpecuniary loss penalties, whether secured or unsecured by a federal tax lien, will be claimed against the debtor's after-acquired property, if the underlying tax liability is not discharged in bankruptcy, and against property secured by a federal tax lien, which is not under bankruptcy adminisration. Rev. Rul. 68–574.

[35] It is provided in Bankruptcy Act § 371 that the discharge of a debtor upon confirmation of an arrangement under chapter XI excludes nondischargeable debts under § 17. The debtor is thus released from all dischargeable taxes. Post-petition interest on a nondischargeable tax claim may be collected from the discharged debtor's after-acquired assets. Similarly, pre-petition nonpecuniary loss penalties pertaining to nondischargeable taxes also survive a chapter XI proceeding and may be collected from the after-acquired assets of the debtor.

[36] Bankruptcy Act § 474 provides that upon confirmation of a chapter XII arrangement, the property dealt with by the arrangement becomes free of all debts affected by the arrangement, except as otherwise provided therein. However, § 476 indicates that the discharge of a debtor upon confirmation of an arrangement excludes debts excepted from discharge under § 17. Thus, post-petition interest and nonpecuniary loss penalties pertaining to nondischargeable taxes are collectible from the after-acquired assets of the debtor.

[37] Bankruptcy Rule 13–404(a) provides in effect that when a debtor in a chapter XIII proceeding completes all payments under the wage earner's plan, he is granted a discharge from all debts provided for by the plan, including nondischargeable debts under Bankruptcy Act § 17 held by creditors who have accepted the plan. Similarly, under Bankruptcy Rule 13–404(b), a debtor who has not completed his payments under the plan due to circumstances beyond his control may also receive such a discharge. (*See also* Bankruptcy Act §§ 660 and 661.) Therefore, if the Service has accepted a plan and the debtor receives a discharge prior to full payment of nondischargeable taxes, such taxes may not be collected from the debtor.

that whenever a tax is denied priority because a debtor has nonfraudulently understated his tax liability and the Service is prohibited from assessing the tax, such tax be made nondischargeable.

Section 2–201—Jurisdiction of the Bankruptcy Courts

Section 2–201(a) provides that the jurisdiction of the bankruptcy court extends to the determination of all controversies arising out of any type of bankruptcy proceeding.

Although section 2–201(a) generally reaffirms the existing jurisdiction of the present bankruptcy court, jurisdiction is extended to other areas, including controversies involving exempt property, and property of the estate regardless of who has possession. Thus, the present distinction between summary and plenary jurisdiction is eliminated. Additional grants of jurisdiction pertaining to the administrative functions of the bankruptcy court are contained in section 2–201(b).

Section 2–208 (section 2–207 of S. 235) provides in part that notwithstanding any other federal or state law, the bankruptcy court is vested with the powers of a court of equity, law, and admiralty. Under section 2–208, the bankruptcy court may issue injunctions, make orders, and enter judgments necessary for the protection of a debtor or his estate, and for the purpose of carrying out the enforcement of the provisions of the Act. Additionally, the basic procedure under present Bankruptcy Act § 17c regarding the bankruptcy court's determination of the dischargeability of tax debts is continued in section 4–506 (b)–(d).

Unlike the present Bankruptcy Act, section 1–104 contains a specific waiver of the sovereign immunity of the Government.

Under present law, a bankruptcy court is one of limited jurisdiction and its power to act must be found expressly or impliedly in the provisions of the Bankruptcy Act.

Bankruptcy Act § 2a confers summary jurisdiction in the bankruptcy court with respect to participants in the proceedings, as well as over others who may be considered to have consented to the court's jurisdiction, or over property in the actual or constructive possession of the bankruptcy court or as to matters affecting the administration of the bankruptcy estate. In particular, the bankruptcy court is vested with subject matter jurisdiction under § 2a(2A) to hear and determine questions as to the amount or legality of any unpaid tax which has not been adjudicated prior to bankruptcy, and under § 2a(12) to determine the dischargeability of debts and to render judgments thereon. (In addition, the bankruptcy court is given jurisdiction under § 62a to determine the costs and expenses of administration.)

Accordingly, the bankruptcy court has jurisdiction under Bankruptcy Act § 2a(2A) to determine the merits of any unpaid tax for which the Service has filed a proof of claim in the proceeding. (If a proof of claim for a tax liability is filed in a bankruptcy proceeding while a proceeding is pending before the Tax Court relating to the same liability, the two courts have concurrent jurisdiction to determine the tax.)

However, absent a specific waiver of sovereign immunity, the Government is immune from suit. This doctrine of sovereign immunity is applicable to proceedings under the Bankruptcy Act. Since there is no express waiver of sovereign immunity contained in the Bankruptcy Act, it is the position of the Government that the bankruptcy court has no personal jurisdiction over the Government and cannot determine the merits of any unpaid tax under § 2a(2A) if the Government has not consented to the jurisdiction of the court by filing a proof of claim in the proceeding. This position is also applicable to the bankruptcy court's determination of the dischargeability of any debt for taxes, pursuant to Bankruptcy Act § 17c (1), (3) (*see also* Bankruptcy Rules 409, 701 (7), 11–48, 12–47 and 13–407).

Discussion

Due to the waiver of sovereign immunity under section 1–104, the Government would no longer be able to contend that the bankruptcy court lacks jurisdiction to determine the dischargeability of any unpaid tax in a case where the debtor seeks determination of the dischargeability of the tax and the Service has not filed a proof of claim. Additionally, as subsequently discussed, the Government would not be able to object to a quick audit necessitated by a trustee's application under section 4–402 for the determination of post-petition

tax liability. Moreover, it appears the comprehensive grant of jurisdiction under section 2–201 would result in the trial of many issues in bankruptcy cases (including issues arising in refund suits, and suits pertaining to property levied on by the Service prior to bankruptcy) on extremely short notice.

Recommendation

Although the provisions pertaining to the waiver of sovereign immunity and the considerable expansion of the jurisdiction of the bankruptcy court may result in increased administrative burdens for the Service and the Department of Justice and necessitate the hiring of additional attorneys and other personnel (provided additional funds are appropriated for hiring such personnel), these provisions are not opposed.

Section 4–402(d)—Application for Determination of Tax Liability

Under section 4–402(d), the bankruptcy court (or, presumably, the district court in a railroad reorganization case) is given jurisdiction to determine the liability of the estate or of a debtor for any unpaid tax incurred during administration of the estate. The trustee or debtor may apply to the court for a determination of such liability by filing a complaint, accompanied by copies of returns certified to have been filed on behalf of the estate for any completed tax periods concerning which a determination of liability is sought.[38] Pro forma returns for any period not yet completed, containing a computation of the tax liability to date and a projection thereof to the anticipated date of the estate's termination, are also required. If the court decides such determination of tax liability is necessary to allow expeditious closing of the estate, it will order service of the complaint and accompanying returns on the appropriate governmental agency, whether or not it is a party to the proceeding, and will also set a time within which the agency is required to appear and show cause why the tax, if any, computed by the trustee or debtor and revised to reflect events occurring prior to the estate's termination, should not be approved.[39]

If the taxing authority undertakes an audit within the prescribed time, the court would grant such continuances as it may find reasonable to permit the audit to be completed expeditiously. Payment of the amount determined by the court's final order would "discharge the trustee or debtor and his predecessors in the administration of the estate for the tax to which the determination relates." Thus, under section 4–402(d) personal liability under 31 U.S.C. § 192, or corresponding state or local law, would be determined. (*See* note 4 to section 4–402, *Report*, pt. II, 98; *see also Report*, pt. I, 292–93.)

It appears the general prohibition in 28 U.S.C. § 2201 against declaratory judgments with respect to federal taxes would not be applicable to the determination of tax liability pursuant to section 4–402(d), due to the jurisdiction of the bankruptcy court under sections 4–402(d) and 2–201(a) to make such determination, and the waiver of sovereign immunity under section 1–104.

Under present law, the basic period of limitations for assessment of an administrative tax liability in a bankruptcy case is three years after the trustee (or other fiduciary) files the appropriate return. Internal Revenue Code § 6501 (a). Further, there is no current statutory requirement for an immediate audit.

As indicated in Plumb, *The Tax Recommendations of the Commission on the Bankruptcy Laws—Tax Procedures*, 88 *Harv. L. Rev.* 1360, 1426 (1975), a trustee wishing to close a bankruptcy estate is caught in a dilemma if he has any doubt regarding the amount of a post-petition tax liability. Under such circumstances, the trustee will generally either: (1) compute the administrative tax liability on the most favorable basis to the estate, and retain enough funds to cover any prospective deficiency assertion by the Service within the three-year period following the filing of the return; or (2) compute the liability on the basis most favorable to the Government, and file a subsequent refund claim. Under either course of action, however, the trustee acts in contravention of his duty under Bankruptcy Rules 605(a) and 903 to wind up ond close the bankruptcy estate expeditiously. Since the trustee of a bankruptcy estate may be-

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[38] It is unclear as to why the debtor would file a complaint under section 4–402(d), since a determination of tax liability pursuant thereto would not affect the debtor's liability under section 5–104(a) or section 7–315(e). *See* Plumb, *The Tax Recommendations of the Commission on the Bankruptcy Laws—Tax Procedures*, 88 *Harv. L. Rev.* 1360, 1440 (1975).

[39] The provision whereby the bankruptcy court can cause a governmental agency to appear and show cause why the tax, if any, as computed and revised by the trustee or debtor should not be approved is not in section 4–402(e) of S. 235.

come personally liable under 31 U.S.C. § 192 if he pays a debt due another creditor of the estate before paying a federal post-petition tax liability, it is important that the trustee obtain an early determination of such administrative tax liability.

In *In re Statmaster*, 465 F. 2d 987 (5th Cir. 1972), the trustee in a liquidating proceeding petitioned the court for an order directing the Government to show cause why he should not be discharged from all federal income tax liability arising from his administration of the estate. Attached to the petition was a corporate income tax return completed for the bankrupt corporation and signed by the trustee. The return pertained to most of the administration period and indicated no tax due. No comparable return had been filed with the Service, and no taxes had been assessed against either the bankrupt or the trustee. The court held that, due to the general prohibition in 28 U.S.C. § 2201 against declaratory judgments in federal tax cases, the bankruptcy court lacked jurisdiction to enter an order discharging the trustee from all potential income tax liability for the period of his administration of the bankruptcy estate. In *In re Dolard*, 519 F. 2d 282 (9th Cir. 1975), however, the court held that the bankruptcy court has jurisdiction under Bankruptcy Act § 2a(2A) to hear and determine the amount or legality of any unpaid income taxes of the bankruptcy estate, and to relieve the trustee from liability therefor, upon application of the trustee even though the Service has not even audited the return, or sent a notice of deficiency or an administrative claim to the fiduciary.

Discussion

Under section 4–402(d), a trustee or debtor may file a complaint seeking determination of the amount of liability for any federal tax incurred during the administration of the estate. If the bankruptcy court is satisfied such determination is necessary to permit expeditious closing of the estate, the Service would have to appear within a time set at the discretion of the court and show cause why the tax, if any, computed by the trustee or debtor (including any tax liability shown on the pro forma return, revised to reflect events occurring prior to termination of the estate) should not be approved. While continuances could be granted by the court to permit the Service to complete an audit begun within the prescribed time, the Service might be forced to complete an audit prematurely in a particular case if such a continuance were not granted. It is believed preferable for Congress to set a specific time limitation in which the return of a trustee (or other fiduciary) must be audited, rather than leaving it to the discretion of the court. Additionally, the Service cannot audit pro forma returns, since such returns are tentative and incomplete when filed.

Recommendation

For the reasons previously discussed, section 4–402(d) in its present form is opposed.

As an alternative to section 4–402(d), consideration should be given to providing the following procedure to be used when necessary to close a bankruptcy estate expeditiously.

With regard to a return or returns previously filed by a trustee (or other fiduciary) for a completed period or periods during the administration of the bankruptcy estate, the trustee may make written application for a prompt determination of the tax liability (if any) for the completed period(s) and a discharge of personal liability therefrom.

The application, with copies of the returns previously filed for the completed periods, would be filed by the trustee with the District Director for the Internal Revenue District in which the case is pending. The District Director would be required to notify the trustee within 60 days after receipt of the application that the returns for the completed periods are either accepted as filed, or are being selected for examination.

If the returns are selected for examination, the District Director would be required to notify the trustee within four months after receipt of the application of the amount of any outstanding tax liabilities for the completed periods.

If the trustee is notified that the returns for the completed periods are accepted as filed, or if he pays the amount of tax due for which he is notified, or if he has not received written notification within four months after the District Director's receipt of his application, he would be discharged from personal liability for any deficiency pertaining to the completed periods for which the returns were previously filed, and would also be entitled to a receipt or writing showing such discharge. The discharge of the trustee under this provision from

personal liability would apply to him in his personal capacity and to his personal assets; it would not be applicable to his liability as a fiduciary to the extent of the assets of the bankruptcy estate in his possession or control.

There is a similar precedent for the suggested procedure in Internal Revenue Code §§ 2204 and 6905, which pertain to the discharge of a fiduciary from personal liability for estate, income and gift taxes. (*See also* Internal Revenue Code § 6501(d), pertaining to request for prompt assessment.)

To alleviate the problem in obtaining prompt determination of the tax liability incurred during the period of administration of a bankruptcy estate, Revenue Procedure 76–23 will be issued in the near future, providing instructions to trustees or other fiduciaries for obtaining expeditious audits of tax returns filed in bankruptcy cases. Under Revenue Procedure 76–23, a written application requesting a prompt audit of completed returns may be filed by the fiduciary with the appropriate District Director, accompanied by a copy of the return or returns previously filed. Within 60 days after the application is received, Audit will advise the fiduciary whether the returns filed are being selected for examination or are being accepted as filed. If the returns are selected for examination, they will be handled on an expedited basis and the fiduciary will be advised in writing of the examination results pursuant to normal closing procedures.

Section 7–315(e)—Collection of Taxes from Debtor or Transferee

Section 7–315(e) (section 4–719(e) of S. 235) provides that all taxes of the debtor "which are assessed within one year after the filing of a petition * * * but which have not been assessed prior to confirmation of a plan," and all post-petition taxes incurred "as a result of the operation of the business of the debtor or the sale of property" of the bankruptcy estate, "may be assessed against and collected from the debtor or any corporation organized or made use of for effectuating a plan under [chapter VII]."[40]

Section 7–315(e) is derived from present Bankruptcy Act §§ 271, 397 and 523, and Bankruptcy Rules 10–403 and 11–33(b)(3)[41] (*see* note 6 to section 7–315, *Report*, pt. II, 260), and is also applicable to railroad reorganization cases under chapter IX (*see* section 9–101).

Generally speaking, in cases under present chapters X (Corporate Reorganizations), XI (Arrangements), and XII (Real Property Arrangements), any pre-petition taxes of the debtor which are assessed after confirmation of the plan and within one year after the petition date, and any taxes incurred during the administration of the estate which are assessed while the case is pending, may be assessed against, collected from, and paid by the debtor or successor corporation.[42] While it is clear the debtor or successor corporation is thus liable for post-petition taxes incurred during administration, it is unclear whether comparable liability exists for those pre-petition taxes of the debtor which are dischargeable.

This same uncertainty would occur under section 7–315(e), which does not differentiate between dischargeable and nondischargeable taxes of the debtor.[43]

Recommendation

It is recommended that section 7–315(e) be clarified to indicate whether a debtor or successor corporation is liable thereunder for dischargeable pre-petition taxes of the debtor.

Sections 4–307 and 9–305—Notices

Section 4–307(e) (section 4–309(d) of S. 235) provides that the notice of information which the administrator is required to mail to all creditors is also to be given to the Department of the Treasury. If papers filed in the case disclose a federal tax liability owed by the debtor, the notice of information must also

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[40] *See also* section 6–104(b)(2) (section 6–401(b)(2) of S. 235) and section 8–401(b) of S. 235.

[41] *See also* Bankruptcy Rule 12–33, as well as Rule 13–305 (which supersedes Bankruptcy Act § 680 in chapter XIII cases).

[42] *See*, respectively: (1) Bankruptcy Act § 271 and Bankruptcy Rule 10–403(1), (2); (2) § 397 and Rule 11–33(b)(3) (A), (B); and (3) § 523 and Rule 12–33 (1), (2).

[43] As previously discussed, though corporate debtors are not entitled to a discharge, a corporation in a reorganization case in effect obtains a discharge when a plan of reorganization binds its creditors to satisfaction of less than the total amounts of their claims in the proceeding. (*See* note 3 to section 4–505, *Report*, pt. II, 134.)

be given to the Department of Justice and to the Service. Section 4–307(e) is applicable to cases under chapters V (Liquidations); VI (Plans for Debtors with Regular Income); and VII (Reorganizations). Although section 4–307(e) is not applicable to cases under chapter IX (Railroad Reorganizations), section 9–305(d) (section 10–303(d) of S. 235) provides that the notice of information which the district court is required to give all creditors, indenture trustees, and equity security holders is also to be given to Treasury, and, if a federal tax liability is disclosed by papers filed in the case, to Justice and to the Service.

With regard to ordinary bankruptcy cases under present law, Bankruptcy Rule 203(g) provides that copies of the notices required to be mailed by the bankruptcy court to all creditors of the bankrupt must be mailed to the District Director for the district in which the case is pending. Bankruptcy Rule 11–24(e) indicates that Rule 203(g) is applicable to cases under chapter XI (Arrangements), and Rule 12–23(d) states that Rule 203(g) applies in cases under chapter XII (Real Property Arrangements). Although Bankruptcy Rule 203(g) is not applicable to cases under chapters X (Corporate Reorganizations) and XIII (Wage Earners' Plans), Rule 10–209(e) provides that copies of notices required to be mailed by the trustee, receiver, or debtor in possession to all creditors must also be mailed to the District Director for the district in which the case is pending, and Rule 13–203(d) contains the same requirement regarding notice to the District Director as does Rule 203(g). In railroad reorganization cases under Bankruptcy Act § 77, General Order 49(6) requires the clerk of the district court to transmit to the Secretary of the Treasury copies of the documents listed in the Order, which includes any petition filed under § 77(a). The clerk is also required to transmit a copy of any such petition to the District Director for the district in which the proceedings are pending. Additionally, under Proposed Bankruptcy Rule 8–209(b), the trustee would be required to mail to the District Director for the district in which the railroad reorganization case is pending all notices required to be mailed to creditors.

Under Bankruptcy Rules 10–104(a) and 10–105(a), a copy of any petition filed in a chapter X case is required to be transmitted by the clerk of the district court (or by the bankruptcy judge when the petition is filed in a pending case) to the District Director for the district in which the case is filed, and to the Secretary of the Treasury. Bankruptcy Rules 11–6, 11–7, 12–6 and 12–7 contain the same requirement regarding petitions filed in cases under chapters XI and XII, respectively. *See also* Proposed Bankruptcy Rules 8–102 and 8–103, under which such requirement would be applicable in railroad reorganization cases.

Discussion

Although the administrator under section 4–307(e) (or the district court under section 9–305(d)) is required to give Treasury prompt written notice of the commencement of a case and of the relief directed in the case, as well as additional written notices of other information required to be mailed to all creditors, such notices would be given the Service (which we assume to mean the National Office, rather than the appropriate District Director) only when papers filed in the case disclose a federal tax liability of the debtor.

Note 4 to section 4–307, *Report*, pt. II, 87, indicates that section 4–307(e) is derived in part from Bankruptcy Rules 203(g), 10–209(e), 11–24(e) and 13–203(d). As discussed previously, under these Rules copies of the notices required to be mailed to all creditors must be mailed to the District Director for the district in which the case is pending. The Commission, however, apparently chose to disregard the requirement of notice to the District Director contained in these Rules, and determined that notice to Treasury would be sufficient. Yet such automatic notice to Treasury in all bankruptcy proceedings would be impracticable and unnecessary. Moreover, the lack of direct notice to the District Director in all bankruptcy cases would delay the determination of whether the debtor owes federal taxes, and whether an immediate assessment is required under Internal Revenue Code § 6871(a). This lack of direct notice to the District Director also would hinder the determination of whether a proof of claim should be prepared and filed in the bankruptcy proceeding.

Recommendation

Sections 4–307(e) and 9–305(d), which require that notice be given to the Service only in cases when the papers filed disclose federal tax indebtedness, would hinder and delay the collection efforts of District Directors. Since every bankrupt is at least a potential federal tax debtor, the appropriate District

Director should automatically receive the same notices required to be mailed to all creditors to alert him to the possibility that a tax debtor may be discharged in bankruptcy. Notice to Treasury in all bankruptcy cases would be impractical; rather, notice should be given to the District Director in every case to secure maximum collections from such proceedings. Therefore, sections 4–307(e) and 9–305(d) are opposed unless the District Director is substituted therein for the Secretary of the Treasury.

Section 4–503—Exemptions

Section 4–503 establishes uniform federal exemptions allowable to individual debtors (but not to corporations or partnerships). Reference to any state or other federal law for determination of exemptions is abandoned.[44]

Significantly, section 4–503(a) provides in part that "[p]roperty allowed as exempt under this section is exempt from creditors holding claims allowable against the debtor's estate." Thus, the exemptions of a debtor under section 4–503 are applicable against federal tax claims in bankruptcy.[45] Also, note 2 to section 4–503, *Report*, pt. II, 128, indicates the Commission intended to supersede the generally less extensive exemption provisions of Internal Revenue Code § 6334.[46]

The provisions of section 4–503 are applicable to cases under chapters V (Liquidations); VI (Plans for Debtors with Regular Income) and VII (Reorganizations).

Present Bankruptcy Act § 17a(1) provides in part that "a discharge shall not be a bar to any remedies available under applicable law to the United States * * * against the exemption of the bankrupt allowed by law and duly set apart to him under this Act." Therefore, because a federal tax lien attaches to a bankrupt's exempt property, if any, the Service may levy upon such property to collect the underlying liability (whether or not a notice of lien has been filed) if the property is not exempt from levy under Internal Revenue Code § 6334(a). (*See generally* Treas. Reg. §§ 301.6331(a)(3) and 301.6334–1(c).)

Discussion

Some of the exemptions in section 4–503 are more restrictive than those in Internal Revenue Code § 6334(a), *e.g.*, "livestock" and "tools of the trade or profession" (section 4–503(c)(1)), as compared with "livestock, and poultry" (§ 6334(a)(2)) and "books and tools necessary for the trade, business or profession" (§ 6334(a)(3)). Conversely, with little or no policy justification, other exemptions in section 4–503 are more liberal than the exemptions under Internal Revenue Code § 6334(a), *e.g.*, "wearing apparel [and] jewelry" (section 4–503(c)(1)), as compared with "[s]uch items of wearing apparel * * * as are necessary for the taxpayer or for members of his family" (§ 6334(a)(1)). (*See also* Treas. Reg. § 301.6334–1(a)(1).)

Further, also with little or no policy justification, the lifetime support exemptions in section 4–503(c) for life insurance proceeds or benefits, and rights under profit-sharing, pension, or similar plans (as well as the immunity from creditors' claims granted under section 4–601(b) to interests in spendthrift trusts) appear to go far beyond providing for the basic needs of the debtor and his family, since they contain no dollar limitations and do not specify the measurement of future support that is "reasonably necessary."

Recommendations

We agree with the basic premise of the Commission that uniform federal exemptions be established under the Bankruptcy Act, in lieu of having state

[44] Section 4–503 of S. 235 establishes minimum federal exemptions and permits the debtor to elect between the federal minimums (with a ceiling at $25,000) or the applicable state exemptions (without any ceiling). *See generally* Plumb, *The Recommendations of the Commission on the Bankruptcy Laws—Exempt and Immune Property*, 61 *Virginia L. Rev.* 1, 9–13 (1975).

[45] Following the close of a bankruptcy case, the Service would apparently be prohibited from levying on the property previously allowed to the debtor as exempt pursuant to section 4–503 to satisfy nondischargeable taxes which were not paid during the case. The exemptions in section 4–503, however, would not be applicable to the collection of federal taxes incurred by the debtor after the filing of the petition (*see* note 10 to section 4–503 *Report*, pt. II, 129).

[46] The intention of the Commission in this regard may require a conforming amendment to Internal Revenue Code § 6334(c), which presently provides that "[n]otwithstanding any other law of the United States, no property or rights to property shall be exempt from levy [for federal taxes] other than the property specifically made exempt by [§ 6334](a)." *See* Plumb, *supra* note 44, at 13.

exemption laws applicable in bankruptcy. Additionally, we are in agreement with the underlying philosophy that the debtor and his family should not be left destitute and should have a basis for rehabilitation. Therefore, we do not object that certain assets of the debtor be exempt from creditors' claims allowable against the bankruptcy estate, including federal tax claims, provided such assets are necessary for the basic needs of the debtor and his family.

We share, however, the concern of Mr. William T. Plumb, Jr., expressed in his statements submitted to the Subcommittee on Improvements in Judicial Machinery, and in his recent law review article on exempt and immune property,[47] that the three lifetime support provisions may enable debtors and their families to be shielded from the duty to pay taxes beyond their basic needs, and may encourage delinquent taxpayers to file petitions in bankruptcy to take advantage of such liberal allowance for future support. We also question the basic philosophical premise that a debtor's family obligations beyond basic needs should come ahead of his duty to pay taxes.

However, the assets of a debtor and his family that should be allowed as exempt from federal tax claims, so as to prevent destitution and provide a basis for rehabilitation, is basically a policy determination which can be best made by Congress. We therefore do not believe it appropriate to set forth specific recommendations regarding the exemptions in section 4–503, other than to suggest, as did Mr. Plumb, that the three lifetime support provisions discussed previously be defined more narrowly as against tax claims. We do oppose, however, the alternative in section 4–503(a) of S. 235 of allowing the total value of property exemptions under applicable state law, since this could give effect to unduly excessive exemptions, *e.g.*, the homestead exemption in Texas, which is not restricted by either the value of the land itself or any of its improvements.

Miscellaneous Recommendation

Internal Revenue Code § 6871(a) provides that upon: (1) the adjudication of bankruptcy of any taxpayer in a liquidating proceeding; (2) the filing or the approval of a petition of or against any taxpayer in any other bankruptcy proceeding; or (3) the appointment of a receiver for any taxpayer, any unassessed deficiency determined in respect of an income, estate, or gift tax imposed on such taxpayer is required to be immediately assessed, notwithstanding the restrictions on assessments imposed by Internal Revenue Code § 6213(a).

Internal Revenue Code § 6213(a) in part provides that, except for Internal Revenue Code § 6861 jeopardy assessments, no assessment of a deficiency in respect of any income, estate or gift tax, or any tax imposed by chapter 42 (Private Foundations)[48] or chapter 43 (Qualified Pension, Etc., Plans)[49] can be made until a notice of deficiency has been mailed to the taxpayer pursuant to Internal Revenue Code § 6212, nor until the expiration of the applicable 90- or 150-day period during which the taxpayer may petition the Tax Court for a redetermination of the deficiency, nor, if a petition is filed with the Tax Court, until its decision becomes final. In turn, Internal Revenue Code § 6212(a) generally provides that if a District Director determines that there is a deficiency in respect of any income, estate, gift, chapter 42 or 43 tax, he is authorized to mail a notice of such deficiency to the taxpayer.

The reference to chapter 42 taxes was added to Internal Revenue Code §§ 6212(a) and 6213(a) by, respectively, Tax Reform Act of 1969, § 101(j) (40) and (42) (Pub. L. No. 91–172, 83 Stat. 530). The reference to chapter 43 taxes was added to Internal Revenue Code §§ 6212(a) and 6213(a) by, respectively, Pension Reform Act of 1974, § 1016(1) (10)(A) and (11)(A) (Pub. L. No. 93–406, 88 Stat. 930).

When the above amendments were made to Internal Revenue Code §§ 6212(a) and 6213(a), no corresponding amendment was made to Internal Revenue Code § 6871(a), apparently due to Congressional oversight. Therefore, it is recommended that Internal Revenue Code § 6871(a) be amended to include provision for immediate assessment of any deficiency in respect of a tax imposed by chapter 42 or 43.

II. SUBSTANTIVE TAX PROVISIONS

The following relates to the proposed amendments to the Bankruptcy Act and the Internal Revenue Code which will affect the income tax liability incurred during the pendency of a proceeding in bankruptcy.

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[47] *See* Plumb, *supra* note 44.
[48] Internal Revenue Code §§ 4940–4948.
[49] Internal Revenue Code §§ 4971–4975.

Section 5-104—Income Taxes

This section contains four subdivisions which will have a major effect on the income taxation of estates in liquidating proceedings, *i.e.*, "straight" bankruptcies. The section is applicable to corporate and non-corporate bankrupts.

Subdivision (a)—Exemption of Trustee From Duty to File Returns or to Pay Taxes

Under proposed section 5-104(a) an estate in a liquidating bankruptcy proceeding will be exempt from income tax (including state and local taxes) unless the estate turns out to be solvent. The exemption extends to operating income as well as gains realized on the disposition of assets. In the event of solvency the amount of the surplus acts as a limit on the amount of tax payable, and not as a limitation of the amount of income which is taxable (Commission Report, Part II, page 188). If the surplus is insufficient to pay all of the taxes the tax claimants are to share in the surplus on a pro rata basis. The statute of limitations on assessment and collection is to be tolled until the estate is closed, and if the trustee neglects to pay the income taxes then the bankrupt shall be liable as a "transferee" of the estate to the extent of any surplus distributed to him.

Discussion

The proposal is directly contrary to existing law. Under current law an estate in bankruptcy is taxable on operating income, nonoperating income, and capital gains generated during the administration of the estate. The resulting taxes are treated as administration expenses and given a first priority under section 64a(1) of the Bankruptcy Act. Under the proposal the Government's position would be reduced from that of a first priority claimant to that of having no claim at all (or at best a last priority claim in the event that the estate is solvent).

We are not in favor of completely exempting estates in liquidating bankruptcy proceedings from income taxation. Congress has traditionally accorded tax claims a high priority in insolvency situations—presumably with the thought that the business of Government comes first and that taxes are the life blood of the Government. It may be the case that the amount of income tax generated during the administration of liquidating bankruptcy proceedings is not large in relation to total federal tax revenues; however, the same could be said with respect to a particular excise tax or with respect to the income taxation of various classifications of taxpayers. We do not believe that this factor should be considered as a valid basis for tax exemption.

Although we do not recommend wholesale tax exemption in the bankruptcy area we realize that in a majority of cases the potential amount of revenue may not be commensurate with the cost of processing and auditing the returns involved. In lieu of completely exempting liquidating proceedings from income taxation we suggest that consideration be given to the enactment of legislation that would substantially reduce the number of returns required to be filed in such cases. For example, consideration might be given to granting a larger tax exemption to estates in liquidating bankruptcy proceedings.

Lastly, under the proposed legislation liquidating bankruptcy proceedings would be taxed differently than proposed chapter VII reorganizations. While all income would be exempt from tax in liquidating proceedings (except to the extent that the estate is solvent) a debtor in a proposed chapter VII reorganization (which would replace the debtor relief provisions contained in chapters X, XI and XII of the current Bankruptcy Act) would be taxed on operating income but not on gains realized on the sale of assets not in the ordinary course of business (except to the extent that the old owners retain an interest in the debtor). Proposed section 7-315(c). Although we do not recommend the tax exemptions proposed with respect to either type of proceeding we do suggest for purposes of administrative feasibility that liquidating and rehabilitation proceedings be taxed in the same manner since the two types of proceedings are readily interchangeable under the current and proposed Bankruptcy Acts.

For example, under the current Bankruptcy Act a debtor may convert a pending liquidating bankruptcy proceeding into a chapter XI arrangement by filing a petition under section 321, and the chapter XI proceeding may in turn be converted back into a liquidating proceeding in the event that the debtor is

unable to persuade a sufficient number of creditors to agree to a plan of arrangement. A proceeding that starts off as a chapter XI proceeding under section 322 of the Bankruptcy Act may likewise be converted to a liquidating proceeding if a plan of arrangement is not confirmed. Similar provisions apply in the chapter X area. Liquidating and rehabilitation proceedings will also remain readily convertible under sections 5–103 and 7–112 of the proposed legislation.

Due to the considerable fluidity between liquidating and rehabilitation proceedings it would appear more practical to apply the same tax rules to each type of proceeding. In fact to do otherwise might encourage debtors to manipulate the status of the proceeding for the purpose of avoiding taxes. For example, if operating income were exempt in a liquidating proceeding and taxable in a rehabilitation proceeding then marginal debtors whose real purpose is to effect an arrangement or a reorganization might be tempted to start off and stay in a liquidating proceeding as long as possible before converting to a rehabilitation proceeding in order to shield operating income. This sort of scheme might be particularly attractive to a debtor that anticipates earning a large amount of operating income over a relatively short period of time such as one with a seasonal business.

Recommendation

The Internal Revenue Service recommends that liquidating and rehabilitation proceedings be taxed in the same manner and that operating income, nonoperating income, and gain from the sale of assets be subject to tax in each type of proceeding. With respect to liquidating proceedings we believe that it would be desirable to substantially reduce the number of returns required to be filed by granting an increased tax exemption to estates that are in a liquidating status at the end of their taxable year.

Subdivision (b)—Termination of Taxable Period By Filing of Petition

Proposed section 5–104(b) provides that a debtor's taxable period is to be terminated on the date a petition in bankruptcy is filed, and that the tax computed for such period may be allowed as a claim against the estate. In the case of an individual debtor the termination is to be tentative, and if the tax computed for the full taxable period (as if no petition had been filed) is less than the tax computed for the terminated period then only the lesser amount shall be allowed as a claim against the estate.

Discussion

Under the present law the commencement of a liquidating bankruptcy proceeding does not interrupt the taxable year of either a corporate or an individual bankrupt. In the case of an individual bankrupt the tax liability for the unbroken taxable year remains a liability of the bankrupt rather than a claim against the estate. The tax liability of a corporate bankrupt for the year in which the petition is filed becomes an administration expense of the estate and as such it is entitled to a first priority under section 64a(1) of the Bankruptcy Act.

In the case of both corporate and individual debtors the tax liability computed under proposed section 5–104(b) for the terminated period would become a fifth priority claim pursuant to proposed section 4–405(a)(5)(A).

In the case of corporate debtors we would favor the proposal if estates in liquidating bankruptcy proceedings are in fact to be exempt from income taxation under proposed section 5–104(a). On the other hand if proposed section 5–104(b) is not enacted (as we recommend) then we would not favor terminating a corporation's taxable year. In the latter event we would favor retaining the existing system whereby a corporation continues to file its return for an unbroken period as if bankruptcy had not occurred. In such event we would also be in favor of continuing the present treatment of corporate income taxes as administration expenses to the extent that they are attributable to taxable years ending after the institution of the bankruptcy proceeding. If proposed section 5–104(a) is not enacted and corporate debtors remain taxable during the pendency of a bankruptcy proceeding then there would not seem to be any compelling reason to terminate the taxable year at the petition date. The current system is feasible in the case of corporate debtors since the tax liability and funds to pay the liability follow the same route. That is, the trustee who must file the return for the unbroken period also has possession of the corporate assets.

We think that the proposal has merit with respect to individual taxpayers regardless of whether proposed section 5–104(a) is enacted. As indicated above, the income tax liability of an individual bankrupt for the year in which the petition is filed remains his liability rather than a claim against the estate. The present system can produce unfortunate results when the tax is attributable to income accrued or collected prior to bankruptcy since the liability remains that of the bankrupt while the assets from which he might have paid the tax pass to his trustee.

Recommendation

The Internal Revenue Service recommends that the proposal be enacted with respect to individual bankrupts. It is not recommended that the proposal be enacted with respect to corporate bankrupts unless corporations are in fact to be tax exempt under proposed section 5–104(a).

Subdivision (c)—Loss Carrybacks and Loss Carryovers

Proposed section 5–104(c) provides that the trustee of the estate of an individual bankrupt shall have the benefit of any refund generated by loss carrybacks attributable to losses sustained prior to bankruptcy. If such losses cannot be utilized as carrybacks then the trustee may carryover the losses against income generated by the estate in bankruptcy during the period of administration. Although the proposed statute does not specify what happens if the trustee is unable to make use of such carryovers the Commission Report states that carryovers "* * * not utilized by the estate would not thereafter be available to the bankrupt." (Commission Report, Part I, page 280.)

Discussion

The proposed subsection essentially follows the decision in *Segal* v. *Rochelle*, 382 U.S. 375 (1966) with respect to loss carrybacks. *Segal* held that a refund attributable to the carryback of a net operating loss sustained by the bankrupt for the taxable year in which the petition in bankruptcy was filed belonged to the trustee rather than the bankrupt since the loss was "rooted in the prebankruptcy past." The proposed subsection changes the *Segal* rule slightly by providing that the loss shall be computed to the date of the petition and shall not be reduced by income earned by the bankrupt during the remainder of the taxable year. Under *Segal* the loss would not be computed until the close of the bankrupt's taxable year, and therefore losses sustained prior to the petition would be offset against the bankrupt's post-petition income. The effect of this slight modification would be that in some cases the trustee will have a larger loss for carryback and carryover purposes and the bankrupt will have a correspondingly larger taxable income for the year in which the petition is filed. We are in favor of the proposal.

We also favor the proposal to make loss carryovers available to the estate and not to the bankrupt but for a different reason than that advanced by the Commission. The reasoning of the Commission is that the creditors rather than the bankrupt should have the benefit of loss carryovers since "* * * the very debts reflecting the loss have been cancelled and the loss has been sustained not by the bankrupt but by his creditors. The bankruptcy law is designed to give the bankrupt a 'fresh start'—not a 'head start.'" (Commission Report, Part I, page 280.)

It is not completely accurate to say that the losses have been sustained by the creditors rather than the bankrupt since the amount of a loss carryover will not necessarily have any relationship to the bankrupt's unpaid debts. However, we are in favor of allowing the estate rather than the bankrupt the use of the loss carryovers since this approach would tend to make the tax consequences to the estate similar to the tax consequences that would have resulted had the debtor liquidated outside of bankruptcy. This approach would also be consistent with the thrust of Rev. Rul. 68–48, 1968–1 C.B. 301 which provides, in part, that the trustee must use the bankrupt's basis and holding period and that the nature of an asset in the hands of the trustee for purposes of determining whether a gain or loss on its sale is capital or ordinary depends upon the nature of the asset in the hands of the bankrupt.

Recommendation

The Internal Revenue Service recommends the enactment of proposed section 5–104(c).

Subdivision (d)—Allocation of Partner's Tax Liability, Refund, or Carryover to the Partnership

Since partnership income (whether distributed or not) is passed through to the individual partners the resulting tax liabilities become debts of the partners rather than the partnership. The Government, as a creditor of the individual partner, must first look to the partner's assets for collection since any claim that it may have against the assets of the partnership will be subordinate to the claims of the partnership creditors under section 5g of the Bankruptcy Act. Section 5g is a marshalling provision which provides that the creditors of individual partners can only reach the surplus (if any) of partnership assets that remains after the partnership creditors have been paid. Conversely, the partnership creditors cannot reach the assets of the partners until their individual creditors have been paid.

Proposed section 5–104(d) contains the following provisions:

(1) The unpaid income tax liability of a partner which is "fairly apportionable" to undistributed partnership income shall be a partnership debt;

(2) The partnership trustee shall have the right to any refund due to a partner to the extent that it is "fairly apportionable" to losses sustained by the partnership which were not reimbursed by the partner;

(3) Any loss carryovers which are allowed to the estate of a bankrupt partner (including a limited partner) under section 5–104(c) shall in turn be allowed to the partnership estate to the extent that such losses are "fairly apportionable" to losses sustained by the partnership.

The term "fairly apportionable" has no precise meaning. "* * * [T]he statute leaves to the equitable powers of the court the determination of what amount is 'fairly apportionable' to the partnership." (Commission Report, Part II, page 188.)

Although proposed section 5–104(d) may be commendable in principle we do not recommend making a portion of a partner's tax liability a partnership debt or allocating a portion of a bankrupt partner's loss carryovers to the partnership estate. We think these proposals interject an element of complexity that will generate administrative problems which will outweigh the equitable result that they are designed to attain. For example, it appears that the Government would have to request the court to determine whether a portion of each partner's tax liability is "fairly apportionable" to undistributed partnership income before it could file an income tax claim in the bankruptcy proceedings. Similar determinations would have to be made by the court whenever the partnership estate or a bankrupt partner's estate filed an income tax return utilizing the bankrupt partner's loss carryovers. This appears to involve an overly cumbersome procedure (particularly in cases involving a large number of partners) that would place an unwarranted strain on the Government's resources.

On the other hand the allocation of the right to a refund would not overly burden the Service provided that the refund check is to be made payable to the partner or the partner's trustee and that any potential allocation of the refund is a matter to be resolved between the partner's trustee and the partnership trustee.

Recommendation

The Internal Revenue Service recommends that proposed section 5–104(d) not be enacted to the extent that it would apportion a partner's unpaid tax liability or loss carryovers to the partnership estate.

Section 7–315—Reorganizations—Special Tax Provisions

Proposed Chapter VII would replace certain debtor rehabilitation proceedings in the current Bankruptcy Act (chapter X reorganizations, chapter XI arrangements, and chapter XII real property arrangements) with a new "reorganization" proceeding. "* * * Relief under the reorganization chapter (chapter VII) will be available to all persons, except insurance and banking corporations, savings and loan associations, railroads covered by chapter IX, and municipalities covered by chapter VIII." (Commission Report, Part II, page 237.) Proposed section 7–315 is comprised of numerous subdivisions containing special tax provisions applicable not only to the new chapter VII "reorganization" proceeding but also to chapter IX Railroad Reorganizations by virtue of proposed section 9–101.

Subdivision (a)—Exemption From Stamp or Similar Taxes

Proposed section 7–315(a) provides that:

The issuance, transfer, or exchange of securities, or the making or delivery of instruments of transfer under any plan confirmed under this chapter, shall not be taxable under any law of the United States, a State, or any subdivision thereof, imposing a stamp or similar tax.

Discussion

The Commission Report states that "Subdivision (a) is derived from § 267 of the present Act, but broadened to cover all taxes similar to stamp taxes." (Part II, page 260.) This exemption is of diminished importance insofar as federal revenues are concerned since the Excise Tax Reduction Act of 1965 repealed the stamp taxes on the issuance and transfer of stocks and bonds and the conveyance of realty.

Recommendation

The Internal Revenue Service does not oppose the enactment of proposed section 7–315(a).

Subdivision (c)—Exemption From Income as a Result of Sales of Assets

Under proposed section 7–315(c) no tax shall be "payable" on gains resulting from the sale of assets "* * * not in the ordinary course of business during the pendency of a case and prior to confirmation, or in respect to sales made pursuant to the provisions of a plan * * *." Losses on such sales would also be disallowed. An exception applies to this "nonrecognition" provision when the owners (whether they be shareholders, partners or a sole proprietor) retain an interest in the debtor. If the owners retain an interest the tax on such gains will be allowed as an administration expense but only to the extent of the value of the retained interest.

Discussion

This provision represents a departure from current law under which gains from the sale of assets, other non-operating income, and operating income are subject to tax. The proposal also differs from the proposed treatment of straight bankruptcy proceedings which would exempt from tax operating as well as non-operating income (proposed § 5–104(a)). It is worth noting at the outset that it is doubtful whether the proposed disallowance of losses realized from the sale of assets not in the ordinary course of business will amount to a quid pro quo for the proposed nonrecognition of gains on such sales. The symmetry is probably more apparent than real since a debtor could avoid having his losses disallowed by merely selling his loss assets prior to the initiation of the reorganization proceeding.

Although the Commission proposes to tax operating income generated during a chapter VII reorganization it believes that to tax gains on sales made out of the ordinary course of business "* * * unfairly burdens the creditors, whose recovery would not have been reduced by the amount of such tax if they had simply seized the debtor's assets without resorting to proceedings under the Act * * *." (Commission Report, Part I, page 281.) We are not persuaded by this reasoning. If a debtor conveyed an asset to his creditor in payment of a debt the tax consequences to the debtor would be the same as if he had sold the asset for the amount of the debt and then turned the proceeds over to the creditor. We see no reason why the tax consequences should be different merely because the asset is sold during the course of a reorganization proceeding. Accordingly, it is our view that non-operating as well as operating income should be taxed when generated during the course of a debtor rehabilitation proceeding such as the proposed chapter VII of reorganization.

An additional reason for taxing non-operating income such as gain from the sale of assets not in the ordinary course of business is that such assets may be subject to substantial nonrecourse liens, *i.e.*, liens on which the debtor is not personally liable.

Nonrecourse liens form the cornerstone for so-called tax shelters since they can be used to generate depreciation deductions far in excess of the amount of money which the taxpayer pays out or becomes obligated to pay out. In theory the taxpayer must pay the piper when he subsequently sells the asset since the balance due on the lien must be included in the "amount realized" on the sale.

It appears to us that if the Commission's tax exemption proposal is enacted then a convenient method of cheating the piper would be to sell assets of this nature in a chapter VII or IX reorganization.

In a similar vein the proposal to exempt gain on the sale of assets not in the ordinary course of business would nullify the depreciation recapture provisions of sections 1245 and 1250 of the Internal Revenue Code. Normally these depreciation recapture provisions override other provisions that provide for nonrecognition of gain since both sections provide that, "* * * Such gain shall be recognized notwithstanding any other provision *of this subtitle*." (Emphasis added, sections 1245(a)(1) and 1250(a)(1).) However, by their terms, these provisions only override nonrecognition provisions in Subtitle A of Title 26 of the United States Code. It seems clear that sections 1245 and 1250 would be overridden by proposed section 7–315(c) since the latter section provides that,

No taxes on or measured by income shall be payable and no loss shall be allowable *under any law of the United States* * * * *now in force or hereafter enacted* * * * in respect to sales of assets not in the ordinary course of business. * * * [Italics added.]

As indicated above we are not in favor of exempting gains from tax merely because they arise from the sale of assets not in the ordinary course of business. The proposed provision to the effect that the tax on such gains will be allowed as an administrative expense to the extent of the value of any interest which the owners retain in the debtor does little to alter our opinion on this score. We believe that this provision would be hard to administer since the type of proceeding in question can span a number of years and the value of any retained interest would generally be ascertainable only toward the end of the proceeding. For example sales may be made in years 1, 2 and 3 but the proceeding might not be terminated until year 5. In this circumstance a question would arise as to how to treat the sales on the income tax returns for years 1, 2 and 3. Moreover, there is always a degree of uncertainty when tax consequences hinge on a "valuation factor." In this regard it appears that valuation could be difficult in the area of proposed chapter VII reorganizations since section 7–301(a) provides that a plan of reorganization may include provisions for "delayed participation rights" in favor of the former owners "* * * conditioned on the court's determination within a period specified in the plan but not later than five years from the date of confirmation that the reorganized debtor or the successor under the plan has attained a financial status that warrants such participation."

Lastly, we suggest that debtor rehabilitation proceedings should be subject to the same tax rules as liquidating bankruptcy proceedings since the two types of proceedings are readily interchangeable. For example under the current Bankruptcy Act a debtor may convert a pending liquidating bankruptcy proceeding into a chapter XI arrangement proceeding by filing a petition under section 321, and the chapter XI proceeding may in turn be converted back into a liquidating proceeding. Liquidation and rehabilitation proceedings will also remain readily convertible under sections 5–103 and 7–112 of the proposed legislation.

Recommendation

The Internal Revenue Service recommends that the same tax rules be made applicable to rehabilitation and liquidating bankruptcy proceedings. It is further recommended that gains from the sale of assets not in the ordinary course of business, other nonoperating income, and operating income should remain subject to taxation.

Subdivisions (b) and (d) of Section 7–315 and Proposed I.R.C. § 172(d)(7)

The above provisions pertain to (1) the nonrealization of income due to debt cancellation, (2) the disallowance of loss carryovers and other deductions to the extent that they are traceable to cancelled obligations and (3) basis reduction.

Subdivision (b)—Exemption From Income Taxes as a Result of Adjustment of Indebtedness

Proposed section 7–315(b) provides, in essence, that a debtor shall not realize income by reason of debt adjustment; however, deductions for current expenses and loss carryovers shall be disallowed to the extent that the obligation to pay such items is cancelled in the proceeding.

The first portion of section 7–315(b) to the effect that no income shall "* * * accrue to or be realized by a debtor * * *" in a chapter VII case by reason of debt cancellation is consistent with existing sections 268, 395 and 520 of the Bankruptcy Act pertaining to chapter X reorganizations, chapter XI arrangements and chapter XII real property arrangements, respectively. Also see Treas. Reg. § 1.61–12(b) to the same effect.

The latter portion of section 7–315(b) to the effect that, for taxable periods ending after the confirmation of a plan, deductions and loss carryovers are to be disallowed to the extent that the obligations to pay such items or the costs entering into their determination or the obligation to repay funds borrowed for the purpose of paying such items or costs are cancelled or reduced would represent a change in the law. See Rev. Rul. 58–600, 1958–2 C.B. 29 which provides, in part, that the cancellation of a taxpayer's debts does not affect his net operating loss carryovers from prior years if he was insolvent before and after the cancellation.

Subdivision (d)—Tax Basis of Property

Proposed section 7–315(d) provides that the tax basis of the debtor's property shall be decreased by the lesser of:

(a) The amount of cancelled debt "* * * which is excluded from gross income *under this section*" (emphasis added), or

(b) "* * * the amount by which the debtor is solvent after the cancellation * * *"

However, in lieu of reducing basis the debtor may elect to treat the cancelled debt as income in the year in which the plan is consummated. Proposed subdivision (d) also provides that a debt cancelled in exchange for an equity security shall not be considered to have been cancelled for purposes of the subdivision. In addition subdivision (d) would not apply to the extent that the debt cancellation resulted in the disallowance of deductions, including loss carryovers, under proposed section 7–315(b).

Although not readily apparent from the proposed statutory language the purpose of limiting the downward adjustment to basis to the lesser of the amount of cancelled debt "excluded from gross income *under this section*" (emphasis added) or the amount by which the debtor is solvent after the cancellation is to equate the adjustment to basis under proposed chapter VII to that which would occur outside of bankruptcy by reason of debt cancellation.

Under section 61(a)(12) of the Internal Revenue Code discharge of indebtedness results in the realization gross income. However, under section 108(a) of the Internal Revenue Code the taxpayer need not include the discharged amount in income if he consents to a decrease in the basis of his assets under section 1017. The general rule that income results from the discharge of indebtedness is subject to to the judicially created exception that income is not realized when the debtor remains insolvent after the cancellation. This exception is also recognized in Treas. Reg. § 1.61–12(b). If the cancellation of a debt does not result in the realization of income by virtue of the fact that the debtor remained insolvent after the cancellation then sections 108(a) and 1017 would not be applicable since there would be no need to rely on section 108(a) to exclude income which was not deemed to have been realized in the first place. Thus, the cancellation of a debt will not result in the realization of income or in a decrease in the basis of the debtor's assets when he remains insolvent.

By the way of contrast if the debt cancellation occurred in a "chapter proceeding" under the Bankruptcy Act then under the literal terms of sections 270, 396 and 522 (relating to chapter X reorganizations, chapter XI arrangements and chapter XII real property arrangements, respectively) the debtor would have to reduce basis in an amount equal to the debt cancelled in the proceeding even though basis would not have been reduced (or reduced only to the extent of solvency) had he accomplished the same result outside of bankruptcy. As indicated, the proposed legislation is designed to eliminate this discrepancy.

Proposed Section 172(d)(7) of the Internal Revenue Code—Net Operating Losses

Proposed section 172(d)(7) provides, in essence, that net operating losses shall be reduced to the extent such losses reflect obligations that are cancelled or reduced in a proceeding under the Bankruptcy Act or otherwise. The amount by which net operating losses are reduced shall not be included in gross income or result in the reduction of basis under section 1017 of the Internal Revenue Code or chapters VII and IX of the proposed Bankruptcy Act.

Discussion

Under the combined provisions of proposed Bankruptcy Act sections 7–315 (b) and (d) and proposed Internal Revenue Code section 172(d)(7) debt cancellation would have the following effect.

(1) The first adjustment would be to disallow for any taxable year ending after the confirmation of the plan of reorganization any deduction for:

* * * expenses, interests, taxes, losses, depreciation, and other items and for loss carryovers reflecting such items, to the extent that the obligation to pay such items or the costs entering into their determination, or the obligation to repay funds borrowed for the purpose of paying such items or costs, is cancelled or reduced in a proceeding under this chapter. (Section 7–315(b).)

In *non-bankruptcy* cases the same result would be reached under proposed section 172(d)(7) of the I.R.C. with the exception that the adjustment would be limited to net operating losses.

It seems clear that the above adjustment prescribed by section 7–315(b) is to be made first (*i.e.*, before any adjustment to basis) since section 7–315(d) provides, in effect, that basis shall not be reduced by reason of a cancelled debt which resulted in the disallowance of a deduction for a loss carryover or other item under subdivision (b). The last sentence of the proposed amendment to I.R.C. § 172(d) contains a similar provision which applies to non-bankruptcy situations in addition to chapter VII and IX proceedings under the proposed Bankruptcy Act.

(2) The second adjustment would be to the basis of the debtor's property under section 7–315(d). Basis would be reduced by the lesser of:

(a) The amount of cancelled debt, "* * * which is excluded from gross income *under this section* * * *" (italics added), or

(b) "* * * the amount by which the debtor is solvent after the cancellation * * *"

It is clear from the Commission Report that the above provision is intended to alter the existing basis reduction provisions of sections 270, 396 and 522 of the Bankruptcy Act under which basis is reduced by the amount of debt cancellation (but not below fair market value) even though the debtor remained insolvent after the cancellation and therefore did not have to rely on the Bankruptcy Act to avoid the realization of income. Commission Report, Part I, page 289.

Elimination of Deductions

We support the proposal to scale down deductions to reflect debt cancellation. However, in its proposed form the legislation may prove ineffective since it appears to require that a cancelled debt be traced to a particular deduction or loss carryover. As a practical matter the tracing requirement will often be difficult if not impossible. For example, if a taxpayer borrowed cash and deposited it in his checking account along with his other cash and daily receipts there would be no way to trace a particular disbursement to the borrowed cash. As a result situations will arise in which debt cancellation will not be taken into account for tax purposes. A cancellation would not result in the realization of income (proposed section 7–315(b)), and if a cancelled debt cannot be traced to a particular deduction or loss carryover then the only potential adjustment would be to basis. However, as a practical matter basis will not be able to be adjusted in many cases since the potential adjustment cannot exceed the amount by which the debtor is solvent.

In view of the foregoing we suggest that the proposed legislation be revised to provide that net operating loss carryovers shall be scaled down by an amount equal to the total amount of debt cancelled in the proceeding regardless of whether it can be shown that the cancelled debt contributed to the net operating loss. If the amount of cancelled debt exceeds the net operating loss carryovers then the excess would be applied to reduce basis to the extent that the debtor is solvent.

Reduction of Basis

We agree with the proposal to limit basis reduction to the extent that the debtor is solvent following debt cancellation. The proposal would put debtors in a chapter VII reorganization proceeding on a par with debtors who manage to have their debts reduced in a non-bankruptcy proceeding. In a non-bankruptcy case a debtor would realize cancellation of indebtedness income only to the extent that he is solvent after the cancellation. Thus any basis reduction under section 1017 of the Internal Revenue Code would be limited by the extent of

the debtor's solvency since the debtor would only have to rely on a section 108(a) election to that extent.

However, we think that the mechanics of reducing basis may need further study. For example, are the basis of all the assets to be reduced prorata or when feasible is a cancelled debt to be traced to the basis of a particular asset? Should the basis of depreciable property be reduced before reducing the basis of nondepreciable property? Currently the regulations under section 1017 of the Internal Revenue Code and Treas. Reg. § 1.1016–7 provide detailed rules covering basis reduction resulting from debt adjustment. We suggest that the proposed legislation be revised to provide that basis shall be reduced in the manner prescribed by regulations to be issued by the Secretary or his delegate. This approach seems particularly appropriate since under the proposed legislation the primary adjustment reflecting debt cancellation will be to net operating loss carryovers, etc., and such adjustments may affect the mechanical aspects of reducing basis.

Proposed section 7–315(d) is silent with respect to what happens when a debtor's basis is smaller than the amount by which basis is to be reduced. We think it would be desirable if proposed section 7–315(d) contained a provision indicating whether the excess, if any, of the amount by which basis is to be reduced under that subdivision over the debtor's adjusted basis shall constitute income to the debtor. In the non-bankruptcy area the amount of cancellation of indebtedness income that can be excluded from income under section 108(a) of the Internal Revenue Code cannot exceed the adjusted basis of the debtor's assets. Any excess amount is includible in the debtor's gross income. Rev. Rul. 67–200, 1967–1 C.B. 15 and Rev. Rul. 70–406, 1970–2 C.B. 16.

Recommendation

The Internal Revenue Service recommends the enactment of proposed sections 7–315 (b) and (d) and proposed section 172(d)(7) of the Internal Revenue Code subject to the following modifications. It is suggested that proposed section 7–315(b) be modified to provide that loss carryovers are to be reduced by the full amount of debt cancellation regardless of whether a particular cancelled debt contributed to the loss. It is also suggested that a provision be inserted in proposed section 7–315(d) to the effect that basis shall be reduced in the manner prescribed by regulations to be issued by the Secretary or his delegate. Lastly, we think that it would be desirable if proposed section 7–315(d) specified whether income shall be realized and recognized in the event that the basis of the debtor's assets is less than the amount by which basis is to be reduced under that section.

Section 7–315(f)—Tax Avoidance

Subdivision (f) of proposed section 7–315 provides as follows:

Tax Avoidance.—If the principal purpose of a chapter VII case was the obtaining of tax benefit, that tax benefit shall be disallowed.

The Commission Report indicates that proposed subdivision (f) is derived from sections 395 and 679 of the Bankruptcy Act. However, sections 395 and 679 operate differently than the proposed subdivision. Sections 395 and 679, which provide that income shall not be realized by reason of debt cancellation, contain the provision "* * * that if it shall be made to appear that the arrangement had *for one of its principal purposes* the evasion of any income tax, *the exemption provided by this section shall be disallowed.*" [Italics added.]

Under proposed subdivision (f) if *the* principal purpose of the chapter VII reorganization was to obtain *a* tax benefit then that tax benefit will be disallowed, but the subdivision "* * * does not require disallowance of other tax benefits if obtaining them was not the principal purpose of initiating the case * * *." Commission Report, Part II, page 261.

It is questionable whether there can be more than one "principal purpose." In *Bobsee Corp.* v. *United States*, the Fifth Circuit considered the term "principal purpose" in connection with section 269 of the Internal Revenue Code and held "* * * that the *principal purpose* is the purpose which exceeds all other purposes in importance * * *." 411 F. 2d 231, 238 (1969).

If there can in fact be only one principal purpose then the proposed subdivision seems objectionable. If the purpose of the debtor in initiating a chapter VII reorganization is to obtain tax benefits A, B and C then it is possible that the proposed subdivision will operate to disallow only one of such benefits. If the debtor's principal purpose was to secure tax benefit "A" then *that* benefit may be disallowed, but the subdivision, "* * * does not require disallowance

of other tax benefits if obtaining them was not the principal purpose of initiating the case * * *." Commission Report, Part II, page 261.

The Internal Revenue Service favors the enactment of a provision similar to proposed section 7–315(f). However, we offer the following suggestions.

(1) It would be desirable to define the meaning of the term "principal purpose" in the statute.

(2) The proposed section should be modified to provide that if the principal purpose is determined to be tax avoidance or evasion then all deductions, credits, allowances and other tax benefits may be disallowed to the extent that they could not otherwise have been enjoyed but for the reorganization proceeding.

(3) In the event that proposed section 5–104(a) is enacted (exempting estates in liquidating bankruptcy proceedings from taxation) it would be desirable to incorporate a similar provision in proposed chapter V.

(4) A provision should be incorporated in proposed section 7–315(f) to the effect that the subdivision is intended to apply *in addition to* rather than in lieu of section 269 of the Internal Revenue Code.

Section 269 operates to disallow deductions, credits and other allowances when the principal purpose of an acquisition is to evade or avoid income tax by securing the benefit of such items.

Proposed Amendments to the Internal Revenue Code Proposed I.R.C. § 47(d)—Investment Credit Recapture

The proposed legislation would amend I.R.C. § 47 by adding a new subsection (d) which would read as follows:

"(d) Property shall not be deemed to any extent to have been disposed or to have ceased to be section 38 property with respect to a taxpayer solely because title to such property is acquired from a taxpayer by his trustee in bankruptcy, or solely because the basis of such property is reduced pursuant to section 1017 of this title or chapter VII or IX of the Bankruptcy Act of 1973."

Discussion

Revenue Ruling 74–26, 1974–1 C.B. 7 holds that the transfer of section 38 property to a trustee in bankruptcy who does not continue the bankrupt's business constitutes a disposition requiring the recapture of investment credit. The Tax Court reached the same conclusion (with five dissents) in *Henry C. Mueller*, 60 T.C. 36 (1973) and was affirmed on this point by the Fifth Circuit at 496 F. 2d 899 (1974). Revenue Ruling 74–184. 1974–1 C.B. 8 holds that the investment credit on section 38 property must be recomputed to reflect a subsequent reduction in the basis of such property under I.R.C. § 1017.

The Internal Revenue Service supports the proposed legislation to the extent that the transfer from the bankrupt to the trustee would not trigger the recapture of investment credit. However, if the basis of section 38 property is subsequently reduced under chapter VII or IX of the proposed Bankruptcy Act or under I.R.C. § 1017 or if the trustee, debtor, or successor corporation subsequently makes a premature disposition then we think that it would be appropriate to recapture the excessive investment credit previously taken by the debtor. However, in cases involving a non-corporate debtor we believe that the recaptured investment credit should constitute a claim against the estate rather than the debtor.

Proposed Amendment to I.R.C. § 302—Stock Redemptions (Railroads)

The proposed legislation would delete paragraph (4) of I.R.C. § 302(b). Section 302(b)(4) provides in essence, that the redemption of stock in a railroad corporation pursuant to a plan of reorganization under section 77 of the Bankruptcy Act shall result in capital gain or loss. The section in effect "* * * exempts the redemption of stock of a railroad corporation in connection with a reorganization under the Act from the usual rules applying dividend treatment to redemptions having the practical effect of dividend distributions * * *." Commission Report, Part I, page 284.

Recommendation

The Internal Revenue Service supports the proposed amendment. We know of no reason for treating insolvent railroad corporations differently from other insolvent corporations.

Proposed I.R.C. § 312 (n) and (o)—Earnings and Profits

It is proposed that I.R.C. § 312 be amended by adding new subsections (n) and (o). Section 312 governs the computation of a corporation's earnings and profits. Distributions to shareholders are taxed as a dividend (ordinary income) to the extent of the distributing corporation's current and accumulated earnings and profits. If there are no earnings and profits a distribution is treated as a return of capital and applied against the shareholder's basis in his stock. Any such distribution in excess of the shareholder's basis is taxed as a capital gain.

Proposed I.R.C. § 312(n)

Proposed subsection (n) provides that earnings and profits shall be increased (or a deficit in earnings and profits shall be reduced) by the amount of debt cancelled in a proceeding under the Bankruptcy Act or otherwise. However, debt cancellation would not result in an adjustment to earnings and profits in the following circumstances:

(1) If the cancelled debt was included in gross income or applied in reduction of the basis of property. This provision merely prevents a double adjustment to earnings and profits since earnings and profits would be adjusted by reason of the inclusion in gross income. Similarly a reduction in basis will eventually affect the earnings and profits account due to the resulting decrease in depreciation deductions and the increased gain (or reduced loss) which will result from a subsequent disposition;

(2) If the cancelled debt consists of items of a deductible nature which had not heretofore been deducted from earnings and profits under the corporation's method of accounting;

(3) If the debt cancellation represents a capital contribution by the shareholders, or

(4) If the interest of the creditors to whom the indebtedness was owing is continued in a substantial manner through the issuance of stock, whether or not of equal value, in consideration of the cancellation or reduction.

Discussion

It is the view of the Service that in a chapter XI proceeding the debtor's earnings and profits account survives if the plan of arrangement merely involves debt reduction or an extended payment period and the debtor corporation emerges from the insolvency proceeding with the same shareholders. In this situation the Service contends that the earnings and profits account should be adjusted to reflect debt cancellation, and that the adjustment may create positive earnings and profits as well as eliminate a deficit. The Tax Court agreed with this position but was reversed by the Eighth Circuit which held that debt adjustment in a chapter XI proceeding does not result in an adjustment to earnings and profits. *Meyer* v. *C. I. R.*, 383 F. 2d 883 (8th Cir. 1967) rev'g and rem'g, 46 T.C. 65 (1966).

On the other hand when an insolvency reorganization entails the use of a new corporation or when the creditors oust the shareholders the cases generally hold that the emerging corporation starts out with a zero earnings and profit account. For example see, *Dunning* v. *United States*, 353 F. 2d 940 (8th Cir. 1965) cert. denied, 384 U. S. 986 (1966); *McCullough* v. *United States*, 344 F. 2d 383 (Ct. Cl.) cert. denied, 382 U.S. 901 (1965); *United States* v. *Kavanagh*, 308 F. 2d 824 (8th Cir. 1962); *Banister* v. *United States*, 236 F. Supp. 972 (E.D. Mo. 1964); and *F. R. Humpage*, 17 T.C. 1625 (1952) Nonacq, 1952–2 C.B. 4; Acq. 1962–2 C.B. 4. The courts appear to ground their decisions on an indeterminate mixture of ingredients: consisting of the purposes of the Bankruptcy Act, the fact of cancellation of debt, new shareholders, and the absence of a taxfree reorganization. The cases in the preceding paragraph dealt with reorganizations occurring in pre 1954 Code years. The status of an earnings and profits account following an insolvency reorganization became less clear with the enactment of I.R.C. § 381 in 1954. Section 381 provides, in part, that if a corporation acquires the assets of another corporation in certain types of reorganizations described in section 368(a)(1) the acquiring corporation shall succeed to numerous tax attributes of the acquired corporation including the acquired corporation's earnings and profits. Section 368 pertains to "normal" reorganizations whereas I.R.C. § 371 pertains to insolvency reorganizations which occur as part of a receivership, foreclosure or similar proceeding or in a chapter X proceeding. The effect, if any, of section 381 on reorganizations

under I.R.C. § 371 is not clear from the statute. For example it is questionable whether section 381 applies to reorganizations under section 371 which also meet the mechanical requirements of one of the section 368 reorganizations to which section 381 applies. The proposed legislation would clear up this uncertainty since section 381 would be amended to make it specifically applicable to section 371 reorganizations and the latter section would be amended to cover the proposed chapter VII reorganization (which would replace the chapter X, XI and XII proceedings in the current Bankruptcy Act).

Under the proposed legislation debt cancellation or reduction will have the same effect on a corporation's earnings and profits account regardless of the form of the insolvency proceeding. The proposal represents a middle of the road approach between cases such as *Dunning, McCullough, Kavanagh* and *Banister*, which hold that a corporation starts out with a "clean slate" or zero earnings and profits following an insolvency proceeding and the *Meyer* case which held that earnings and profits are not affected by debt adjustment in a chapter XI proceeding. Subject to the modifications suggested below we agree with the approach taken in proposed section 312(n).

The specific objection we have to proposed section 312(n) pertains to the treatment of accrued interest. As indicated above, earnings and profits would not be adjusted under proposed *Code* § 312(n):

(2) If the cancellation or reduction of indebtedness constitutes a capital contribution by shareholders; or

(3) If the interest of the creditors to whom the indebtedness was oweing is continued in a substantial manner through the issuance of stock, whether or not of equal value, in consideration of the cancellation or reduction.

When a shareholder forgives a debt owed by the corporation the transaction generally amounts to a contribution to the capital of the corporation (as opposed to cancellation of indebtedness income to the corporation) to the extent of the principal of the debt. Treas. Reg. § 1.61–12(a). We suggest that the language of proposed section 312(n) be modified to provide that the accrued interest portion of any debt forgiven by a shareholder does not constitute a contribution to capital and that the corporation's earnings and profits account is to be adjusted to the extent of the forgiven interest when the earnings and profits account reflects the previously accrued interest by reason of the fact that the debtor corporation was on the accrual basis. The mere accrual of interest would not be reflected in the earnings and profits account of a cash basis taxpayer since the amount of earnings and profits is dependent on the method of accounting employed in computing taxable income. Treas. Reg. § 1.312–6(a).

We also believe that when a creditor surrenders a bond or other debt plus a claim for accrued interest in exchange for stock of the debtor corporation the receipt of the stock should not be considered as the equivalent of a payment of the accrued interest. Thus we suggest that proposed section 312(n) be modified to provide that in such cases the accrued interest portion of the debt shall be deemed to have been cancelled and an accrual basis debtor's earnings and profits account shall be adjusted to reflect such cancellation. Although it may be reasonable to conclude that shares of stock issued in exchange for debt are in substitution for the principal amount of the debt it is unrealistic to treat such shares as also constituting a payment of accrued interest since the value of the shares will generally not even equal the principal amount of debt. This factor is further aggravated by interest that accrues during the pendency of the bankruptcy proceeding. The filing of a petition suspends the running of interest on pre-petition debts for purposes of collection or distribution. *Nicholas v. United States*, 384 U.S. 678 (1966). On the other hand the interest on such debts continues to accrue for tax purposes even though it is obvious that it will not be paid. Rev. Rul. 70–367, 1970–2 C.B. 37. We believe that this factor furnishes additional support for the proposition that an exchange of debt for equity in an insolvency proceeding should not be treated as a payment of the accrued interest on the debt.

Proposed I.R.C. 312(o)

Proposed subsection (o) provides as follows:

* * * If the interest of any of the stockholders of a corporation is extinguished as the result of a proceeding under the Bankruptcy Act of 1973, the deficit in earnings and profits of the corporation, adjusted as provided in subsection (n), shall be reduced (but positive earnings and profits shall not be created) by the amount of the capital account attributable to the shares so extinguished.

Recommendation

The Internal Revenue Service suports the enactment of proposed section 312(o). The deficit earnings and profits to be eliminated is not attributable to investments made by the creditors who succeed to the ownership of the corporation.

Proposed I.R.C. § 354(c)—Exchange of Stock and Securities

Currently I.R.C. § 354(c) provides that section 354(a)(1) (and so much of section 356 as relates to section 354) shall apply to certain railroad reorganizations whether or not they constitute a "reorganization" within the meaning of I.R.C. § 368(a). Section 354(a)(1) provides for nonrecognization of gain or loss at the shareholder level when stock or securities in a corporation that is a party to a reorganization are exchanged solely for stock or securities in that corporation or in another corporation that is a party to the reorganization. However, the nonrecognition provision of subsection (a)(1) does not apply to the receipt of "excess securities", *i.e.*, the receipt of securities in exchange for stock or the receipt of securities having a larger principal amount than the securities exchanged therefor. The treatment of the receipt of "excess securities" and other "boot" is governed by I.R.C. § 356. Under section 356 gain will be recognized to the extent of the "boot" received in an exchange pursuant to a plan of reorganization, but losses continue to receive nonrecognition treatment regardless of whether or not boot is received. Gain recognized under section 356 may be treated as a dividend or as capital gain depending on the circumstances.

Under the proposed amendment I.R.C. § 354(c) would be made applicable to proposed chapter VII reorganizations as well as to railroad reorganizations. In addition amended section 354(c) would provide that the term "a party to a reorganization" includes the acquiring corporation and a corporation which is in control of the acquiring corporation.

Discussion

The Internal Revenue Service supports the proposed amendment. The proposal to include a corporation in control of the acquiring corporation as being within the definition of a "party to a reorganization" would bring insolvency reorganizations into conformity with normal reorganizations in this respect and allow the stock or securities of the corporation in control of the acquiring corporation to be received under I.R.C. § 354(a) without the recognition of gain or loss. The term "control" is defined in I.R.C. § 386(c).

We also agree with the proposal to make exchanges by shareholders and security holders in insolvency reorganizations subject to the provisions of I.R.C. § 354(a) (and so much of section 356 as relates to that section). Currently such exchanges are governed by I.R.C. § 371(b). Although under section 371(b)(2) gain is taxable to the extent of any "boot" received on an exchange the receipt of "excess securities" would not constitute "boot" under § 371(b)(1). The proposed amendment would correct this defect.

Recommendation

The Internal Revenue Service recommends that the proposed amendment to I.R.C. 854(c) be enacted.

Proposed I.R.C. § 356(d)(2)(B)(i)—Boot

The proposed legislation would amend section 356(d)(2)(B)(i) by deleting the phrase "(other than subsection (c) thereof)."

Recommendation

The Internal Revenue Service supports the proposed amendment. The effect of the deletion would be to extend the "excess securities—boot" provisions of section 356(d) to section 371 insolvency reorganizations.

Proopsed I.R.C. § 371—Reorganizations in Certain Receivership and Bankruptcy Proceedings

Section 371 pertains to exchanges by corporations and security holders in insolvency reorganizations. No gain or loss is recognized if a corporation in a receivership, foreclosure, or similar proceeding or in a chapter X proceeding transfers its property pursuant to a court order to another corporation organized or made use of to effectuate a plan of reorganization in exchange solely

for stock or securities in such other corporation. If "boot" is received in addition to stock or securities then gain will be recognized to the extent of any retained "boot," but no gain is recognized if the "boot" is distributed pursuant to the plan of reorganization. I.R.C. § 371(a). These "boot" provisions parallel the provisions of I.R.C. § 361(b) relating to normal reorganizations.

No gain or loss is recognized by the shareholders or security holders of the acquired corporation on an exchange of their stock or securities solely for stock or securities in a corporation organized or made use of to effectuate the plan. Gain is recognized to the extent of any "boot" received on such an exchange, but the receipt of "excess securities" will not constitute "boot" under I.R.C. § 371(b). No loss shall be recognized at either the corporate or the shareholder level by reason of the receipt of "boot." I.R.C. § 371(c). Finally, I.R.C. § 371(d) provides that the assumption of a liability or the acquisition of property subject to a liability shall be governed by the rules of section 357 of the Code.

The proposed legislation would amend I.R.C. § 371 as follows:

(1) The section would be extended to cover railroad reorganizations which are now covered by I.R.C. § 374.

(2) The reference to chapter X proceedings would be replaced by a reference to chapter VII proceedings since proposed chapter VII will supplant the current chapter X, XI and XII proceedings.

(3) Proposed section 371(a)(1)(B) would permit the tax-free receipt of stock or securities of a corporation which is in control of the acquiring corporation (as "control" is defined in I.R.C. § 368(c)).

(4) The provisions contained in current section 371(b) relating to taxation at the shareholder level would be deleted. The taxation of shareholders and security holders would be governed by proposed section 354(c) and section 356.

Recommendation

The Internal Revenue Service supports the proposed amendment. We know of no reason why insolvent railroads should not be subject to the same reorganization provisions as other insolvent corporations. The remaining proposals would place insolvency reorganizations on a par with normal reorganizations. We think this is generally desirable.

Proposed I.R.C. § 372(a)—Basis Adjustment

Current section 372(a) provides that in a reorganization to which I.R.C. § 371(a) applies the basis of property in the hands of the acquiring corporation shall be the same as it was in the hands of the transferor corporation (increased by the amount of gain recognized by the transferor corporation) notwithstanding section 270 of the Bankruptcy Act (which would reduce basis by the amount of debt cancellation but not below fair market value) and that basis shall not be reduced under I.R.C. § 1017 by reason of a discharge of indebtedness.

Current section 372(a) only applies to I.R.C. § 371(a) transactions, and the latter section applies when the reorganization entails a transfer of the debtor corporation's assets to another corporation organized or made use of to effectuate the plan of reorganization. As a result basis will be reduced to reflect debt cancellation under section 270 of the Bankruptcy Act (but not below fair market value) when the reorganization consists of an internal recapitalization but not when the reorganization involves the transfer of the debtor's assets to another corporation.

The proposed legislation would amend I.R.C. § 372 to provide that, subject to the provisions of chapters VII and IX of the Bankruptcy Act of 1973, the basis in the hands of the acquiring corporation shall be the same as it would be in the hands of the corporation whose property was acquired when section 371(a) applies to the acquisition and that in such cases basis shall not be adjusted under section 1017 by reason of a discharge of indebtedness pursuant to the plan of reorganization.

Discussion

Under the proposed amendment basis reduction will be the same whether the reorganization involves an internal recapitalization of the debtor or a transfer to a successor corporation since the carryover basis provision in proposed section 372(a) is made "subject to the provisions of chapters VII and IX of the Bankruptcy Act * * *." In this regard proposed Bankruptcy Act section 7-315(d) (which will also apply to proposed Chapter IX railroad reorganiza-

tions by virtue of proposed Bankruptcy Act section 9–101) provides for the reduction of the basis of the debtor's property or property transferred to any person required to use the debtor's basis in whole or part. We agree with the proposed amendment since we believe that basis should be reduced to same extent regardless of whether or not a successor corporation is utilized to effectuate the plan of reorganization. However, it appears that the proposed amendment involves a serious oversight.

As indicated, under proposed Bankruptcy Act section 7–315(d) basis will be reduced in the same manner regardless of whether the reorganization involves an internal recapitalization or a transfer to a successor corporation. However, the basis reduction provisions of proposed section 7–315(d) will only apply to proposed chapter VII and IX reorganizations whereas I.R.C. § 371(a) applies to "receivership, foreclosure or similar proceedings" in addition to proposed chapter VII and IX proceedings. Thus if there is a transfer in a receivership. foreclosure or similar proceeding I.R.C. § 371(a) will apply, and if section 371(a) applies there will be a carryover basis under I.R.C. § 372(a)—which presumably would not be reduced under proposed Bankruptcy Act section 7–315(d) since the proceeding would not involve a chapter VII or IX reorganization. Nor would basis be reduced under I.R.C. § 1017 to reflect debt cancellation since proposed I.R.C. § 372(a) specifically so provide (as does current section 372(a)).

It appears to us that the basis reduction provisions of I.R.C. § 1017 (which become applicable when an election is made to exclude cancellation of indebtedness income under I.R.C. § 108(a)) should be made specifically applicable to I.R.C. § 371(a) transactions which do not involve chapter VII or IX reorganizations. Otherwise there will be a discrepancy in the treatment of basis since basis will be reduced (under proposed Bankruptcy Act section 7–315(d)) when an I.R.C. § 371(a) transaction involves a chapter VII or IX but not when the transaction involves a "receivership, foreclosure, or similar proceeding" effectuated under some other law.

Recommendation

The Internal Revenue Service supports the proposed amendment of I.R.C. § 372(a); however, as indicated above, we urge that the amendment be modified to provide that basis shall be reduced under I.R.C. § 1017 when income is excluded under I.R.C. § 108(a) in insolvency proceedings not governed by the proposed Bankruptcy Act.

Proposed Repeal of I.R.C. § 374—Railroad Reorganizations

The Internal Revenue Service supports the proposal to repeal I.R.C. § 374 and make I.R.C. § 371 applicable to railroad reorganizations. We know of no reason for treating railroad reorganizations differently from other insolvency reorganizations.

Proposed Amendments to I.R.C. §§ 381 and 382—Carryover of Tax Attributes

Section 381 provides that if a corporation acquires the assets of another corporation in specified transactions the acquiring corporation succeeds to numerous tax attributes of the transferor corporation including net operating loss carryovers and positive or deficit earnings and profits. Section 381 applies when a parent acquires the assets of a subsidiary in connection with a complete liquidation under I.R.C. § 332 (except when under I.R.C. § 334(b)(2) the parent determines its basis in the liquidated assets by reference to its basis in the subsidiary's stock) or when a corporation acquires substantially all of the assets of another corporation pursuant to a reorganization described in I.R.C. § 368(a)(1) (A),(C),(D) or (F).

In certain circumstances I.R.C. § 382 operates to eliminate or reduce net operating loss carryovers that would otherwise be allowable. Under subsection (a) of section 382 a corporation's net operating loss carryovers are completely eliminated if: (1) at the end of its taxable year any one or more of its 10 major shareholders own stock in the corporation which is at least fifty percentage points more than such person or persons owned at either the beginning of such taxable year or at the beginning of the prior taxable year; (2) the increase in percentage points is due to either a purchase or a decrease in the amount of the corporation's outstanding stock; and (3) the corporation does

not continue to carry on a trade or business substantially the same as that conducted before any change in the percentage ownership of its stock.

Under subsection (b) of section 382 if, in a reorganization specified in I.R.C. § 381(a)(2), either the transferor or the acquiring corporation has a net operating loss carryover and the shareholders of such corporation, as the result of owning stock in the loss corporation, own after the reorganization less than 20 percent of the stock of the acquiring corporation then the net operating loss carryovers will be reduced by 5 percent for each percentage point that the continuing interest of such shareholders falls short of 20 percent.

Discussion of the Proposed Amendments

The legislation would amend I.R.C. § 381(a) by adding a new paragraph (3) which would make the carryover provisions of section 381 applicable when corporate assets are transferred in a proceeding governed by I.R.C. § 371(a). As matters now stand the relationship of section 381 to reorganizations under section 371(a) is not clear. For example, as previously indicated, the statute does not specify whether section 381 applies to section 371(a) transactions which also meet the mechanical requirements of one of the I.R.C. § 368(a)(1) reorganizations to which section 381 is specifically applicable. This question would no longer exist under the proposed legislation since *Code* § 381 would apply to all 371(a) transactions regardless of whether they qualify under one of the appropriate subparagraphs of I.R.C. § 368(a)(1). We agree with the proposal to treat insolvency reorganizations on a par with other reorganizations with respect to the carryover tax attributes.

The proposed legislation would also amend I.R.C. § 381(a) by adding a provision under which subsection (c) tax attributes would be apportioned among the transferor corporation (if it continues) and the transferee corporation (or corporations) when, in an I.R.C. § 371(a) transaction, no one corporation acquires substantially all of the assets necessary to operate the debtor's trade or business or such part of the trade or business that is to be continued. Under the proposed amendment the Secretary or his delegate would prescribe regulations determining whether and to what extent:

(i) The transferor corporation (if it continues to exist) shall retain or take into account any of the items referred to in this subsection,

(ii) Any corporation shall be deemed an acquiring corporation for the purpose of succeeding to or taking into account any of such items, and

(iii) The operating rules of subsection (b) shall be applied.

However, if a corporation acquires a "substantial portion" of the debtor's assets (as distinguished from "substantially all" of such assets) then the regulations are to provide that such corporation shall be deemed to be an "acquiring corporation" with respect to the items referred to in I.R.C. § 381(a) (1) and (2) (relating to net operating losses and positive or deficit earnings and profits). In such cases the (c) (1) and (2) attributes would be apportioned, under the regulations, among the transferor corporation and the acquiring corporation (or acquiring corporations to the extent appropriate to the retained and transferred assets. The remaining section 381(c) tax attributes would, under the regulations, be treated "* * * in a manner appropriate to their character and the relationship thereof to the assets and liabilities of the respective corporations."

We are opposed to the proposed amendment to I.R.C. § 381(a) to the extent that it provides that a debtor corporation's tax attributes can be apportioned among more than one acquiring corporation or that such attributes can be apportioned between a debtor corporation (if it continues to exist) and an acquiring corporation (or corporations). We believe that it would be preferable to treat insolvency reorganizations on a par with normal reorganizations for purposes of applying section 381. In this regard I.R.C. § 381 does not apply to divisive reorganizations. Treas. Reg. § 1.381(a)-1(b)(3). For purposes of section 381 there can be only one "acquiring corporation" even though the transferor's assets ultimately wind up in several subsidiary corporations following a reorganization. Treas. Reg. § 1.381(a)-1(b)(2). Moreover, the situation described by the proposed amendment under which several corporations could acquire the assets of the debtor corporation with no one corporation acquiring substantially all of the assets necessary to operate the part of the debtor's business that is to be continued seems to suggest a transaction that is more in the nature of a liquidation than a reorganization.

The proposed legislation would amend I.R.C. § 382(a) (1) by adding a provision to the effect that an increase in percentage points resulting from an exchange of debt for stock in an I.R.C. § 371(a) transaction shall not be considered for purposes of disallowing a net operating loss carryover unless the creditor obtained the debt for the purpose of acquiring the stock. We agree with the proposed amendment. We also agree with the proposed addition of a new paragraph (7) to I.R.C. § 382(b) which would provide that creditors of a loss corporation immediately before the institution of a proceeding described in I.R.C. § 371(a) shall be considered as stockholders and that the stock received in the acquiring corporation by such creditors in exchange for their claims (other than claims acquired for the purpose of acquiring such stock) shall be considered as owned by them by reason of their having been deemed to have owned stock of the loss corporation.

Although we agree with the proposed amendments to I.R.C. § 382 which, in effect, insure that an exchange of debt for equity in an insolvency proceeding under I.R.C. § 371(a) will not violate the continuity of interest rules in I.R.C. § 382 (a) and (b) we believe that the following additional amendments should be made to I.R.C. §§ 382 and 383.

Section 382(b)(1) should be amended to cover transactions under I.R.C. § 371(a). Currently section 382(b)(1) applies to reorganizations specified in I.R.C. § 381(a)(2). The proposed legislation would amend section 381(a) by the addition of a new paragraph (3) which would make the section applicable to I.R.C. § 371(a) transactions. However, technically section 382(b) would not be applicable to section 371(a) transactions since it only refers to reorganizations specified in section 381(a)(2). We believe that this is merely an oversight since the proposed addition of a new paragraph (7) to section 382(b) clearly indicates that section 382(b) is to be applicable to section 371(a) transactions.

Similarly, I.R.C. § 383 should be amended to cover transactions under I.R.C. § 371(a). Section 383 provides, in part, that in the case of reorganizations specified in section 381(a)(2) the limitations in section 382(b) regarding the carryover of net operating losses shall also apply to certain other tax attributes such as investment credit carryovers, capital loss carryovers, etc. Technically section 383 would not apply to section 371(a) transactions since under the proposed legislation such transactions would be specified in section 381(a)(3) rather than section 381(a)(2). Again, this is believed to be merely an oversight.

Recommendation

The Internal Revenue Service supports the proposed amendments to I.R.C. §§ 381 and 382 except to the extent that the proposed amendment to section 381(a) would permit the tax attributes specified in section 381(c) to be divided among two or more corporations.

In addition, it is recommended that I.R.C. §§ 382(b) and 383 be amended to specifically cover I.R.C. § 371(a) transactions. As indicated, we believe that the failure to do so in the proposed legislation was a mere oversight.

ADDITIONAL RECOMMENDATIONS

Creation of Separate Taxable Entity in Rehabilitation Proceedings Involving Noncorporate Debtors

When a *corporation* enters into a proceeding under the Bankruptcy Act it continues as the same taxable entity. This holds true regardless of whether the corporation enters into a liquidating bankruptcy proceeding or a rehabilitation proceeding such as a chapter X reorganization or a chapter XI arrangement. When a *noncorporate* debtor enters into a *liquidating bankruptcy* proceeding the bankrupt individual's taxable year continues as if bankruptcy had not occurred, but a new and separate taxable entity comes into being—the estate in bankruptcy.

The tax status of a *noncorporate* debtor in a debtor *rehabiltation* proceeding such as a chapter XI arrangement is less clear. It is the position of the Service that when a *noncorporate* debtor enters into a *rehabilitation* proceeding a separate taxable entity is created as in the case of a liquidating bankruptcy. We favor taxing rehabilitation proceedings on the same basis as liquidating bankruptcy proceedings since the two types of proceedings are, as previously noted, readily interchangeable under the current and the proposed Bankruptcy Acts.

For example under the current Bankruptcy Act a debtor may convert a pending liquidating bankruptcy proceeding into a chapter XI arrangement by filing a petition under section 321, and the chapter XI proceeding may in turn be converted back into a liquidating proceeding in the event that the debtor is unable to persuade a sufficient number of creditors to agree to a plan of arrangement. A proceeding that starts off as a chapter XI proceeding under section 322 of the Bankruptcy Act may likewise be converted to a liquidating proceeding if a plan or arrangement is not confirmed. Liquidating and rehabilitation proceedings will also remain readily convertible under sections 5–103 and 7–112 of the proposed legislation.

At the present time it is fairly well established by administrative rulings and case law that a separate taxable entity is created when a noncorporate debtor enters into a liquidating bankruptcy proceeding. On the other hand the limited amount of case law that exists is against the Service's position that a separate taxable entity is created when a noncorporate debtor enters into a rehabilitation proceeding such as a chapter XI.

We believe that the conversion factor makes it desirable to treat both types of proceedings on the same bases for purposes of determining whether a separate taxable entity comes into existence when a proceeding is initiated. If a separate taxable entity is created in the case of liquidating bankruptcies but not in the case of rehabilitation proceedings it is apparent that the tax situation would be chaotic when, for example, a liquidating bankruptcy proceeding is converted into a rehabilitation proceeding and then back into a liquidating bankruptcy proceeding—all of which would be possible over a relatively short period of time. The confusion would be aggravated if the rules regarding the taxation of operating income and capital gains differed in liquidating and rehabilitation proceedings.

In view of the interchangeability between liquidating and rehabilitation proceedings it would also be desirable to have legislation supporting the Service's position that a separate taxable entity is created when a *noncorporate* debtor enters into either type of proceeding.

Tentative Refunds

Under I.R.C. § 6411 a taxpayer may apply for a tentative carryback adjustment of a tax for a prior year based on a claimed net operating loss carryback, investment credit carryback, work incentive program carryback or capital loss carryback. The claimed adjustment (which will result in a tentative refund unless such adjustment is setoff against another outstanding tax liability of the taxpayer) must be allowed within 90 days unless the application contains errors of computation which, in the opinion of the Service, cannot be corrected within such 90 day period or material omissions. For purposes of computing the amount of the tentative adjustment the Service must accept the taxpayer's figures, that is, it cannot challenge the amount of the claimed operating loss, etc. (except for computational errors). If the taxpayer's tentative claim eventually turns out to have been erroneous the Service must initiate steps to collect the erroneous adjustment.

We suggest that consideration be given to amending I.R.C. § 6411 by the addition of a provision to the effect that the Service may disallow an application for a tentative adjustment if it determines that collection will be in jeopardy should it subsequently be determined that the tentative adjustment was erroneous. For example, it seems to make little sense to allow a tentative refund to a bankrupt taxpayer when it is probable that the Service will only be able to recoup a portion of the refund via a claim in the bankruptcy proceeding if it turns out that the refund was excessive.

Interest Accruals During Proceeding

The filing of a petition in a chapter or liquidating proceedings suspends the accumulation of interest on pre-petition debts for purposes of distribution. *Nicholas* v. *United States*, 384 U.S. 678 (1966). However, interest continues to accrue for tax purposes on secured debts even though it is obvious that it will not be paid Rev. Rul. 70–367, 1970–2 C.B. 37. Although the Service is presently reconsidering Rev. Rul. 70–367 it would nevertheless be desirable to have legislation to the effect that no deduction shall be allowed with respect to interest which accrues during a bankruptcy proceeding on pre-petition debts unless and until such interest is actually paid.

CHART I.—ESTIMATED AMOUNTS OF FEDERAL TAXES CLAIMED AND COLLECTED PURSUANT TO PROOFS OF CLAIM FILED IN ASSET CASES[1]

	Bankruptcies commenced	Number proofs of claim filed	Amounts claimed	Amounts collected
A. Estimated receipts from proofs of claim filed—all taxes:				
Fiscal year 1974	189, 513	8, 333	$90, 000, 000	$11, 000, 000
Fiscal year 1975	254, 484	11, 200	120, 500, 000	15, 000, 000
Fiscal year 1976	275, 000	12, 100	130, 000, 000	17, 000, 000
B. Estimated receipts—income tax claims (IMF and BMF):				
Fiscal year 1974			58, 000, 000	6, 500, 000
Fiscal year 1975			77, 000, 000	9, 000, 000
Fiscal year 1976			83, 500, 000	9, 500, 000
C. Estimated receipts—trust fund amounts (withheld income/FICA):				
Fiscal year 1974			18, 000, 000	3, 000, 000
Fiscal year 1975			24, 000, 000	4, 000, 000
Fiscal year 1976			26, 000, 000	4, 500, 000
D. Estimated receipts—other taxes, interest, and Penalties:				
Fiscal year 1974			14, 000, 000	1, 500, 000
Fiscal year 1975			19, 000, 000	2, 000, 000
Fiscal year 1976			20, 500, 000	3, 000, 000

[1] The estimated amounts collected relate only to collections during the base fiscal year through the following November, in asset cases commenced during the base fiscal year. Therefore, the estimated amounts collected do not include subsequent collections.

CHART II.—ESTIMATED AMOUNTS OF FEDERAL TAXES COLLECTED UNDER BANKRUPTCY ACT § 64a(4) PURSUANT TO PROOFS OF CLAIM FILED IN ASSET CASES[1]

A. Taxes which became legally due and owing within 3 years preceding bankruptcy:	
Fiscal year 1974	$1, 500, 000
Fiscal year 1975	2, 000, 000
Fiscal year 1976	2, 000, 000
B. Taxes which became legally due and owing more than 3 years preceding bankruptcy:	
1. Not assessed and bankrupt failed to make timely return (§ 17a(1)(a)):	
Fiscal year 1974	7, 000, 000
Fiscal year 1975	9, 500, 000
Fiscal year 1976	10, 000, 000
2. Assessed within 1 year preceding bankruptcy and bankrupt failed to make timely return (§ 17a(1)(b)):	
Fiscal year 1974	16, 000
Fiscal year 1975	22, 000
Fiscal year 1976	24, 000
3. Not reported on return and not assessed due to prohibition on assessment (§ 17a(1)(c)):	
Fiscal year 1974	62, 000
Fiscal year 1975	84, 000
Fiscal year 1976	90, 000
4. When bankrupt made false or fraudulent return or willfully attempted to evade or defeat (§ 17a(1)(d)):	
Fiscal year 1974	4, 000
Fiscal year 1975	53, 000
Fiscal year 1976	57, 000
5. Collected or withheld by bankrupt but not paid over (§ 17a(1)(e)):	
Fiscal year 1974	2, 000, 000
Fiscal year 1975	3, 000, 000
Fiscal year 1976	3, 000, 000

[1] These amounts are not mutually exclusive. Thus, some overlap exists.

STATEMENT OF WILLIAM T. BAGLEY, CHAIRMAN COMMODITY FUTURES TRADING COMMISSION

Mr. Chairman, and members of the Subcommittee, I wish to thank you for this opportunity to present the views of the Commodity Futures Trading Commission ("CFTC") on S. 235 and S. 236, which would make significant amendments to the Bankruptcy Act. I will address myself to the need for and the desirability of amendments to section 60 of the Bankruptcy Act which would govern bankruptcy liquidations of futures commission merchants, clearing houses, commodity options dealers, and leverage transaction merchants. In particular, I will stress the need for amendments to the Bankruptcy Act which will provide for protection of the commodity customers [1] of such persons.

The CFTC was created by the Commodity Futures Trading Commission Act of 1974 ("CFTC Act") (Pub. L. 93-463, 88 Stat. 1389), which made substantial amendments to the Commodity Exchange Act ("CE Act") (7 U.S.C. 1-22). This legislation vested in the CFTC extensive regulatory powers over "the nation's $400 billion commodity futures trading industry," [2] powers much broader than those previously vested in any of the predecessors of the CFTC. Indeed, the House Report described the CFTC Act as

"* * * the first complete overhaul of the Commodity Exchange Act since its inception, and * * * a comprehensive regulatory structure to oversee the volatile and esoteric futures trading complex." [3]

The commodity futures trading industry has recently grown into a $600 billion industry. Over 32 million commodity futures contracts were traded last year on the various commodity exchanges designated as contract markets by the CFTC. In addition, there is growing activity in related areas which are outside the realm of the traditional futures exchanges. For instance, there has been a noted increase in the number of persons trading in commodity options and leverage contracts. On any given day, there are hundreds of millions of dollars of commodity customers' funds on deposit with futures commission merchants, clearing houses, commodity options dealers, and leverage transaction merchants.

The protection of commodity customers in the event of the bankruptcy of a futures commission merchant, a clearing house, a commodity options dealer, or a leverage transaction merchant is of primary concern to the CFTC. In most instances the relationship of such persons to their customers is that of a trustee to a beneficiary, a fiduciary relationship of the highest order; however, the treatment which commodity customers will be accorded by a trustee in bankruptcy is, in the main, open to speculation. To date, bankruptcy trustees have employed a form of tracing to protect commodity customers' funds in the event of the bankruptcy of a futures commission merchant. This treatment appears to be the result of a combination of pre-1938 law (the date of the enactment of section 60e of the Bankruptcy Act) dealing with the bankruptcies of securities broker/dealers and present day law governing the bankruptcies of persons who hold assets in trust for others. In addition, vague analogies have been drawn to section 60e of the Bankruptcy Act and the Security Investors Protection Act.

The CFTC believes such ad hoc approaches are inadequate to protect the funds of commodity customers on deposit with the various persons engaged in the commodity futures trading industry. The size of the industry and the unique problems which may be encountered in the event of the failure of a futures commission merchant, a clearing house, a commodity options dealer, or a leverage transaction merchant make it imperative that Congress amend the Bankruptcy Act to provide specific statutory protection for commodity customers. In order to do so, Congress must, of course, have a thorough understanding of the commodity futures industry and of the nature and function of each of the participants in the industry. I intend my submission to provide the Subcommittee with such an understanding. In addition, I shall include the

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[1] As used in this statement, the terms "customer" and "commodity customer" refer to commodity futures customers only.

[2] 120 Cong. Rec. H2929 (daily ed. April 11, 1974).

[3] H.R. Rep. No. 93-975, 93d Cong., 2d Sess. 1 (1974).

specific concerns and recommendations of the CFTC. However, many areas now under the regulation of the CFTC were previously unregulated by any federal agency or subject to only superficial federal regulation. Furthermore, certain areas of the futures industry are newly developed and undergoing a process of rapid evolution. I therefore request the opportunity, on behalf of the CFTC, to amend this submission in the future should such amendment appear necessary.

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(Note: A detailed summary of the recommendations urged in this submission with respect to futures commission merchants; CFTC recommendations with respect to clearing houses; and those with respect to commodity options dealers and leverage transaction merchants, and, in addition, a short summary of the recommendations with regard to futures commission merchants are included.)

THE TRADITIONAL COMMODITY FUTURES MARKET SYSTEM

Perhaps the best place to begin my discussion is with the definition of a commodity futures contract. There is no one definition which has gained industry-wide acceptance. Nor has Congress provided a statutory definition in either the CE Act or the CFTC Act. Nonetheless, for purposes of this submission, a commodity futures contract might be defined as:

"A standardized contract for the purchase and sale of a commodity for future delivery, traded or executed on a contract market designated as such by the CFTC."

The definition might also include the following unique characteristic of a futures contract: that delivery upon such contract seldom occurs and is rarely anticipated under normal market conditions.[4]

The method in which a futures contract is entered into on each contract market, or exchange, is basically the same. At the center of each transaction are two floor brokers, one a buyer and one a seller. Both must be members of the contract market.[5] Each floor broker engages in an open and competitive bidding process in a designated trading area (often called a "pit" or a "ring") on the floor of a commodity exchange or contract market whereby bids and offers are shouted or otherwise broadcast to all other floor brokers in the trading area.[6] Whenever a bid and an offer correspond, a contract is formed, a trade is made.[7]

Once a floor broker has entered into a contract, whether for himself or for another person, he must have his trade "cleared" through the clearing house of the exchange. However, not all members of the exchange can submit trades to the exchange's clearing house for clearance. Only those contract market members who are also members of the clearing house can do so. Consequently, a floor broker who is not a member of the exchange's clearing house must submit the contracts he has entered into on the floor of the exchange to a clearing member for presentation to the clearing house.[8] The clearing member, in turn, submits the trades to the clearing house for clearance.

The clearing process on a commodities exchange is somewhat unique and is certainly the heart of the futures industry. Initially, when a futures contract is entered into on the floor of a commodities exchange, there is a distinct buyer and a distinct seller to the contract. These parties may be the opposite floor brokers themselves or the persons for whom they entered into the contracts;

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[4] Delivery of the underlying commodity occurs with respect to only approximately three percent of all contracts.

[5] Section 4 of the CE Act provides, in part: It shall be unlawful for any person to deliver for transmission through the mails or in interstate commerce by telegraph, telephone, wireless, or other means of communication any offer to make or execute, or any confirmation of the execution of or any quotation or report of the price of, any contract of sale of any commodity for future delivery on or subject to the rules of any board of trade in the United States, or for any person to make or execute such contract of sale, which is or may be used for (a) hedging any transaction in interstate commerce in any commodity or the products or byproducts thereof, or (b) determining the price basis of any such transaction in interstate commerce, or (c) delivering any commodity sold, shipped, or received in interstate commerce for the fulfillment thereof, *except*, in any of the foregoing cases, *where such contract is made by or through a member of a board of trade which has been designated by the* [*CFTC*] *as a "contract market"* * * *.[Italics added.]

[6] 17 CFR § 1.38(a) provides: All purchases and sales of any commodity for future delivery on or subject to the rules of a contract market shall be executed openly and competitively by open outcry or posting of bids and offers or by other equally open and competitive methods, in the trading pit or ring or similar place provided by the contract market, during the regular hours prescribed by the contract market for trading in such commodity: *Provided, however,* That this requirement shall not apply to such transactions as are executed noncompetitively in accordance with written rules of the contract market which have been submitted to and approved by the Commission, specifically providing for the noncompetitive execution of such transactions.

[7] At first glance, the floor of a typical commodity exchange may bear some resemblance to that of a stock exchange. However, the two types of exchanges are quite different. Rather than extend the length of this testimony needlessly, I will avoid pointing out the numerous differences between the securities industry and the futures industry, except in those instances where such distinguishing comparisons prove necessary or useful.

[8] A membership in an exchange clearing house must be purchased just as a membership on the exchange itself must be purchased. Such memberships may often cost tens of thousands of dollars. In addition, clearing houses generally impose significantly greater financial requirements upon their members than those imposed by the exchanges on their members. As a consequence, while all floor brokers are members of the exchange itself, only a minority are also clearing members of the exchange. Most clearing house memberships are not owned by individual floor brokers but rather by clearing firms, either directly or through their sponsorship of a partner or officer in the firm.

in either situation, a specific person can be identified to each side of the contract. When the clearing house of the exchange accepts a trade for clearance, the individualized nature of the futures contract changes. The traditional industry description is that the clearing house becomes "the buyer to every seller and the seller to every buyer." In a very real sense this is exactly what happens.

Once a trade or contract has been accepted by the clearing house for clearance, the floor brokers who entered into the contract, or the persons for whom the floor brokers made the trade, can look only to the clearing house for performance of the obligations due them under the contract. A floor broker and the person on whose behalf the floor broker enters into a transaction no longer have any duty to the opposite floor broker to the trade or to the person for whom the opposite floor broker executed the trade. It is to the clearing house that each floor broker and his principal must look for performance on the contract and it is to the clearing house that each floor broker or his principal owes a duty of performance. In this manner the clearing house becomes a party to every contract on the exchange. And where, prior to clearing, there was but one contract between two floor brokers or their principals, there are now two contracts: one between the "sell" floor broker or his principal and the clearing house, and another between the "buy" floor broker or his principal and the clearing house.[9]

At the end of the trading day, the clearing house computes the number of open trades or contracts[10] presented for clearance by each clearing member. Separate computations are made of the number of open trades presented by the clearing member for his proprietary or house account (the account in which the clearing member's own trades and those of closely related persons, etc., are carried) and of the number of open trades presented by the clearing member for his customers' account (the account in which the trades of unrelated persons are carried). The clearing house then compares that day's open trades or contracts in each of these accounts to the open trades or contracts in such accounts as of the close of trading the previous day. (Separate computations and comparisons are also made for each future of each commodity traded on the exchange.) On the basis of these comparisons, the clearing house makes what are known as original margin calls to each clearing member. An original margin call is a demand on the part of the clearing house that the clearing member make a security deposit to insure that the clearing house will receive performance on the contracts it has accepted for clearance. (The amount of such security deposit varies from clearing house to clearing house, and from commodity to commodity, but in general equals between one and ten percent of the purchase price of the contract.) Two such calls are made to each clearing member, one for his house account and one for his customers' account. If the clearing member fails to make the required security or original margin deposit, the clearing house has the power to terminate its contractual relationship with the clearing member by entering into a corresponding but opposite contract on the clearing member's behalf. By so doing, the clearing house liquidates the clearing member's trades; it closes out his position in the market. As noted earlier, while the clearing house recognizes the existence of the

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[9] As will be discussed later, while the clearing house recognizes the rights of commodity customers, it deals only with its clearing members. The actual contractual situation is much more complex. The clearing house is contractually bound to its clearing members, not the customers on whose behalf clearing members present trades for clearing. The clearing member, not the clearing house, is contractually bound to its customers.

In addition, the exact manner in which the clearing house is substituted into each contract varies from clearing house to clearing house. However, it is always accomplished through a contractual agreement which is set forth in either the exchange's or the clearing house's bylaws and rules, or both. The legal effect of such contractual substitution might be described loosely as a novation of the original contract through the simultaneous assignment of rights and delegation of duties under the contract to the clearing house by both parties to the contract upon its acceptance by the clearing house for clearance.

[10] While all trades or contracts accepted by a clearing member must be presented to the clearing house for clearance, only open trades or contracts are considered in this computation, the original margin computation. An open trade or contract is a trade or contract which has not been offset by a corresponding but opposite trade or contract. For example, a floor broker who buys one contract of December wheat for his own account will have an open trade or contract in that future until he sells one contract of December wheat. If, by the close of trading on the day he bought the December wheat contract, the floor broker has not sold one contract of December wheat for his own account, the buy contract will appear on the clearing house's books at the end of the day's trading as an open trade or contract. The floor broker will be said to have an open long position in December wheat of one contract.

customers of its clearing members, and in fact takes action to protect them, it deals directly only with its clearing members. It is the clearing member who is called upon to make the margin deposits to secure the contracts of its customers, and it is only the clearing member who can make the required deposit and thereby keep his customers' trades open; his customers cannot.

In addition to making its daily original margin computations, the clearing house also makes another set of daily computations. For each future of a commodity, the clearing houses computes the sum of:

1. The net open position (total buy contracts minus total sell contracts) in a clearing member's account as of the close of trading the previous day multiplied by the difference between the settlement price for the previous day (the price at which such contracts were trading at the close of trading the previous day) and the settlement price for that day, plus

2. The sum of all contracts presented for clearance by the clearing member that day multiplied by the difference between the price at which each contract was entered into and that day's settlement price.

The sums for each future of each commodity are then added together. Again, two such computations are made for each clearing member, one for his house account and one for his customer's account.

The clearing house uses this latter set of daily computations to make "variation margin calls or payments" to its clearing members ("settlements"). A variation margin call is a demand by the clearing house that a clearing member pay to the clearing house any losses the member has suffered, either in his own account or in his customers' account, as a result of an adverse movement of the market that day. A variation margin payment is a payment by the clearing house to a clearing member to account for any profits accruing to the member or his customers as a result of a favorable movement of the market that day. All losses and gains are netted out in the same account, so that only two variation margin calls or payments are made to each clearing member on any day, one for his customer's account and one for his house account.

A simple example may be helpful at this point. Assume that clearing member A bought one contract of December '76 live hogs yesterday at 44, which also happened to be yesterday's settlement price, and one contract of June '77 cattle today at 46. Assume further that A's customers bought one contract of March '77 pork bellies yesterday at 66, also yesterday's settlement price, and one contract of November '76 fresh eggs today at 59. Then assume that today's settlement prices were as follows:

Contract:	*Settlement price*
December 1976 live hogs	45
June 1977 cattle	44
March 1977 pork bellies	69
November 1976 fresh eggs	59

A's house and customers' variation margin accounts with the clearing house would then show the following:

A'S HOUSE ACCOUNT

Contract	Change in settlement price	Change in price from purchase to settlement	Number of contracts	Settlement
December 1976 live hogs	+1		1	+1
June 1977 cattle		−2	1	−2
Total				−1

A'S CUSTOMERS' ACCOUNT

Contract	Change in settlement price	Change in price from purchase to settlement	Number of contracts	Settlement
March 1977 pork bellies	+3		1	+3
November 1976 fresh eggs		0	1	0
Total				+3

The clearing house would therefore make a variation margin call to A to pay the one unit loss suffered in his house account. On the other hand, the clearing house would make a variation margin payment of three units to A on behalf of his customers for the three unit profit enjoyed by those customers as a result of today's favorable price movement in pork bellies.

While this example is oversimplified, it should make clear the nature of the variation margin or settlement system. Simply, it is a system whereby profits and losses in the futures market as the result of price changes in the market are realized each day in full.

One final note with respect to the variation margin system seems appropriate at this point. Variation margin payments made by clearing members are exactly that, payments. They constitute losses. Once paid out by a clearing member to the clearing house, they are gone. They are not deposits, as are original margin deposits.

As previously mentioned, delivery on a futures contract rarely occurs. Instead, most persons who have attained an open position by entering into a futures contract, close out that position by entering into another corresponding contract, but on the opposite side from that on which they entered their first contract. The two contracts offset each other. For example, a person who bought contract of December '76 wheat in April closes out his position by selling one contract of December '76 wheat in October.[11] When a contract carried by a clearing house for a clearing member is offset by a corresponding but opposite contract, the clearing house returns the original margin deposited by the clearing member to margin the first contract (and, of course, makes no original margin call with respect to the second contract).

What a "buy" clearing member or his customer wishes to take delivery on a futures contract, he merely maintains his open long position in the futures market by failing to enter into an offsetting futures contract on the opposite or "sell" side and awaits delivery. A "sell" clearing member or his customer who wishes to make delivery on a futures contract must also maintain his open position in the futures market by not entering into an offsetting futures contract on the opposite or "buy" side. However, in addition, the "sell" clearing member must also deliver to the clearing house a notice of intent to deliver on the contract. Such notice must be given prior to delivery on the contract and can only be delivered to the clearing house on certain days during, or just prior to the beginning of, the delivery month on the contract (e.g., notice of intent to deliver on a December '76 wheat contract can be tendered to the clearing house only in December, or on the last trading day in November, of 1976).

Once a notice of intent to deliver on a futures contract has been accepted by the clearing house, another unique aspect of the clearing house system comes into play. The clearing house delivers the notice to a "buy" clearing member who has an open long position in that same contract, generally the clearing member who has the oldest open long position in that contract either in his customers' or house account. When this notice is "stopped," i.e., received and not retendered,[12] by the "buy" clearing member, the "sell" clearing member who originally tendered notice to the clearing house and the "buy" clearing member, and their respective customers, are once again identified to a specific contract. The contract once again becomes individualized. However, it would be pure chance if these two clearing members and their respective customers, if any, were opposite parties to the same futures contract when they originally opened their positions on the floor of the exchange.[13]

A simple example may help illustrate precisely what occurs. Assume six clearing members, A through F, with A, B, and E having customers a, b, and

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[11] Such offsets of corresponding opposite positions in the same future of the same commodity on the same contract market must take place unless such contracts are purchases or sales constituting "bona fide hedging transactions" or are sales made during a delivery period (not the case in this example) for the purpose of making delivery during such period. See 17 CFR § 1.46.

[12] Exchange and clearing house rules frequently permit delivery notice to be retendered to the clearing house if the clearing member closes out his open position in the contract by entering into a corresponding but opposite contract shortly after receipt of the notice. Of course, this can only be done where trading in the contract has not ended.

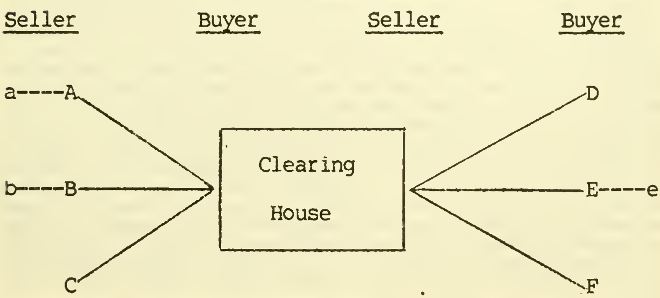
[13] Since all futures contracts are standardized, and since all profits and losses are realized prior to delivery through the payment of variation margin or settlement, which must be maintained on a contract until it is liquidated or delivered upon, the fact that the parties identified to the contract for delivery are different from the parties to the original contracts is not as critical as it would be in a traditional contract situation.

e respectively. Assume that in April of 1976 A through F each entered into a December '76 wheat contract for either their house or their customers' account and presented these trade to the clearing house for clearance. Assume further that B(b), C, D and E(e) all close out their positions prior to December of 1976 and that only A(a) and F decide to deliver and to accept delivery, respectively, on their contracts. When A(a) tenders delivery notice to the clearing house, the clearing house will deliver that notice to F. A (and his customer, a) will have to make delivery to F and F will be required to accept delivery from A(a), despite the fact that each is not the party with whom the other originally contracted. The following diagram will illustrate this:

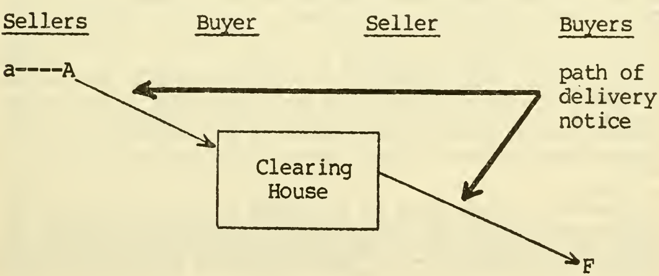
1. April 8—parties enter contracts.

Sellers		Buyers
a----A	contract	D
b----B	contract	E----e
C	contract	F

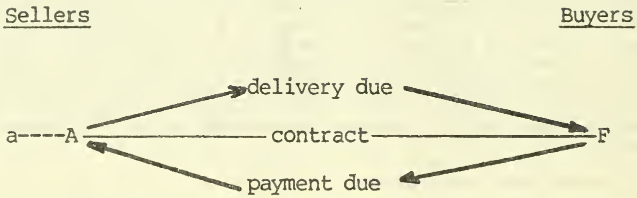
2. April 8—clearance.



3. December—B(b), C, D and E(e) have closed out their positions. A tenders delivery notice to clearing house, which tenders it to F, in turn.



4. December—A(a) and F identified to contract.



As can be noted from the diagram above, once the contract again becomes individualized, i.e., identified to two specific clearing members and their customers, the clearing house is "substituted out" of the contract. It is no longer the buyer to the seller or the seller to the buyer. However, the clearing house does require the payment of variation margin up until the date of delivery. The clearing house also retains control over the original margin deposits made by its clearing members to secure their (or their customers') performance on the contract and the continuing payment of variation margin. Typically, the clearing house will release the original margin deposits of both clearing members after delivery and payment have been made, retaining control over such deposits until that time to guarantee such performance.[14]

At this point I would like to summarize the three basic functions of the clearing house in the futures market system. First, by becoming the buyer to every seller and the seller to every buyer, the clearing house, through the variation margin or settlement system, guarantees that the party who has made a profitable trade will in fact receive that profit through the daily payment of variation margin or settlement by the clearing house. Second, through the delivery notice system, the clearing house guarantees that each seller who tenders notice to the clearing house will have a specific buyer to look to for payment upon delivery and that each buyer who stops notice will have a specific seller to look to for delivery. Since the price of the future parallels that of the physical commodity (where the futures market is functioning properly) and since variation margin calls and payments are made up to the delivery date on a contract, delivery should take place at or very near the cash market price. This means that default on delivery or payment can generally be covered readily in the cash market (assuming adequate deliverable supplies) and that the release of a buyer's or seller's original margin deposit is generally sufficient incentive for performance. This leads us to the third basic function of the clearing house: to retain original margin deposits to insure that performance.

This concludes my introduction of the futures market system. At this point I will describe the role of the futures commission merchant (a classification which includes all clearing members who clear trades for others) in this system and the relationship between such persons and commodity customers. I will then explain how futures commission merchants do and must handle commodity customers' funds and the risks these customers are subjected to in the event of the bankruptcy of such persons. In the course of this explanation, I will present the CFTC's concerns for the protection of commodity customers' funds in the event of the bankruptcy of a futures commission merchant and the CFTC's recommendations as to how such funds should, in fact, be protected under any amendment to the Bankruptcy Act. I will then turn my attention to the other participants in the commodity futures industry and related industries whose bankruptcies require special treatment under the Bankruptcy Act.

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[14] In addition, the clearing house and the exchange for which it clears trades generally have several other rules which serve to compel performance on contracts. For example, default on delivery may result in a fine, the closing out of all the futures positions held by the clearing member, and/or suspension or expulsion from either the exchange or the clearing house, or both. The clearing house and the exchange are required to enforce such rules pursuant to section 5a(8) of the CE Act and 17 CFR §§ 1.53 and 1.54.

THE FUTURES COMMISSION MERCHANT

As previously noted, section 4 of the CE Act, 7 U.S.C. 6,[15] prohibits any person from entering into a futures contract except "where such contract is made by or through a member of a board of trade which has been designated by the [CFTC] as a 'contract market.'" Therefore, since contract market membership is limited both by the physical constraints of the contract market and by the cost of such membership, a member of the general public who wishes to enter into a futures contract must do so through a member of a contract market who will place his order for him; in other words, a floor broker.

As I discussed earlier, all futures contracts entered into by a floor broker, whether for his own account or on behalf of another person, must be submitted to a clearing member of the contract market so that the clearing member can, in turn, submit the trade to the clearing house of the exchange for clearance. Therefore, a member of the general public who wishes to enter into a futures contract must also eventually become a customer of a clearing member of the contract market.

As previously explained, when a clearing member of an exchange submits a customer's contract to the clearing house for clearance, he will be required to deposit original margin to insure performance on the contract. In addition, the clearing member may also be required to make daily variation margin or settlement payments to the clearing house in the event of adverse price movements in the market. As a consequence, when a clearing member accepts a customer's contract for clearance, he requires the customer to deposit margin with him to cover his original margin deposits and his variation margin payments to the clearing house. The deposit the customer puts up with the clearing member is called "initial" margin.

In general, the amount of initial margin a customer must deposit with the clearing member for each contract he enters into is substantially greater than the amount of original margin the clearing member is required to deposit with the clearing house to insure performance on the contract.[16] The clearing member requires such additional initial margin to cover variation margin calls made on the contract by the clearing house. Whenever the payment of variation margin reduces the level of margin a customer has on deposit with the clearing member below a designated level, for example, 75 percent of the amount of initial margin originally deposited to margin the contract, the clearing member will issue a "maintenance" margin call to the customer requiring him to deposit sufficient additional funds, securities, and property to bring the level of margin on deposit with the clearing member up to 100 percent of the original initial margin deposit. Just as original margin is returned to the clearing member by the clearing house when the contract is offset or performance is rendered thereon, so too is initial margin (along with any profit on the transaction which has not previously been disbursed to the customer) returned to the customer by the clearing member when the customer closes out his position (although the clearing member will generally retain

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[15] See note 5.

[16] Some exchange clearing houses use a gross system to determine the original margin their clearing members must deposit; in other words, a certain amount must be deposited as original margin with the clearing house for each open contract it accepts for clearance, regardless of any other contracts it accepts. Clearing members of such clearing houses generally require initial margin of their customers substantially in excess of this amount.

Other exchange clearing houses use a net system to determine their original margin requirements; in other words, margin is required on only the net open long or short position in each future in each account of a clearing member. Under this system, a clearing member with customers who have bought 10 contracts of December '76 wheat and sold 15 contracts of December '76 wheat will have a net short open position in his customers' account of 5 contracts. He will therefore be required to deposit original margin on 5 contracts only. Clearing members of clearing houses which determine margin under a net system generally require initial margin of a customer equal to the amount of original margin the clearing member would be required to deposit to margin that customer's contracts alone. This may even be required by exchange or clearing house rules. Since many customer positions are offset or netted out at the clearing house level, this results in substantial excess initial margin deposits at the clearing member level.

In addition, futures commission merchants in general will not carry trades for a customer unless that customer opens his account with the futures commission merchant with an initial deposit of some minimum figure which has no relation to the amount required to margin the customer's trades at the clearing house. An example of such a minimum deposit might be $5,000.

such margin in the customer's account and not physically return it unless the customer requests his clearing member to do so).

As you will recall, this portion of my submission is entitled "The Futures Commission Merchant." Section 2a(1) of the CE Act defines the term "futures commission merchant": [to] mean and include individuals, associations, partnerships, corporations, and trusts engaged in soliciting or accepting orders for the purchase or sale of any commodity for future delivery on or subject to the rules of any contract market and that, in or in connection with such solicitation or acceptance of orders, accepts any money, securities, or property (or extends credit in lieu thereof) to margin, guarantee, or secure any trades or contracts that result or may result therefrom.

A clearing member who accepts trades for clearance from other persons is therefore a futures commission merchant. But the term futures commission merchant includes numerous persons who are not clearing members of all the contract markets on which they accept customer's orders.

A futures commission merchant firm, whether a sole proprietorship, a partnership or a corporation, generally becomes a member of a contract market through the membership of an owner, a partner or an officer. The futures commission merchant is then eligible to be a clearing member of the exchange. However, very few futures commission merchants are members, let alone clearing members, of every exchange. In fact, several futures commission merchants are not clearing members of any contract market. A customer of a futures commission merchant may nonetheless desire to enter into a futures contract through his futures commission merchant on an exchange in which the futures commission merchant is not a member.[17] The futures commission merchant is able to accept such a customer order by placing the order with a floor broker of the exchange in question for execution and by having a clearing member of that exchange clear the resulting trades or contracts. In so doing, the futures commission merchant becomes the customer of the clearing member futures commission merchant he uses to clear his customer's trade on the contract market of which he is not a member. A clearing member futures commission merchant used by another futures commission merchant to clear his customer's trades is sometimes called a carrying futures commission merchant.

For purposes of explaining the CFTC's concerns in the event of the bankruptcy of a futures commission merchant, it will be beneficial to give the chronology of a typical futures transaction from its outset with the customer's order to its termination with the return of the customer's initial margin and any profits to the customer by his futures commission merchant. To simplify my discussion, this example will assume the customer places his order initially with a futures commission merchant who is a clearing member of the appropriate contract market. Where CFTC concerns involve a more complicated factual situation, that will be so indicated and discussed. The simplified chronology follows:

1. Customer places order with futures commission merchant.
2. Futures commission merchant requires initial margin deposit before attempting to have customer's order executed.[18]
3. Customer makes initial margin deposit with futures commission merchant.
4. Futures commission merchant places order with floor broker on floor of exchange.
5. Floor broker executes order on floor of exchange and returns executed trade to futures commission merchant for clearance.
6. Futures commission merchant presents contract to clearing house of exchange for clearance.
7. Clearing house accepts contract for clearance and makes margin call, both original and variation, to clearing member futures commission merchant.

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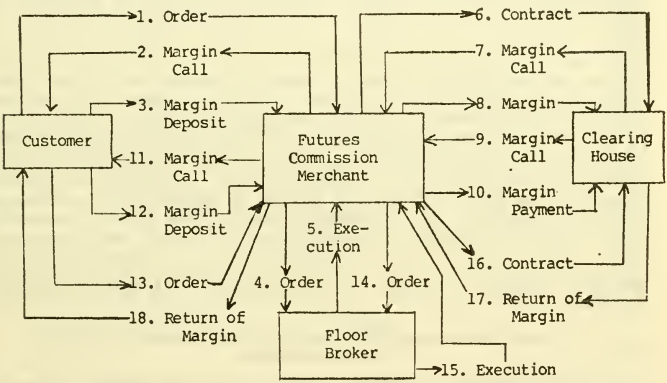
[17] This might be done for a variety of reasons, for example, the customer's confidence in the ability of his futures commission merchant to place his order with a floor broker in such a way as to obtain the best execution possible or the convenience of conducting all his futures transactions through a single firm.

[18] In the case of a known client placing an order with the futures commission merchant, the futures commission merchant may not require that the customer's margin deposit actually be received prior to having the order executed and the resulting contract cleared. Instead, the futures commission merchant may, for short periods of time (for example, while a customer's check is in the mail, etc.), use his own funds to margin such trades with the clearing house. As will be discussed later, this use of house funds to margin customer trades presents certain problems should the futures commission merchant become bankrupt.

8. Futures commission merchant makes original margin deposit and variation margin payment to clearing house.
9. Adverse movements in market result in additional variation margin calls to futures commission merchant.
10. Futures commission merchant makes additional variation margin payments.
11. These additional variation margin payments result in the reduction of the customer's initial margin with the futures commission merchant below, for example, 75 percent of its original level and in a subsequent maintenance margin call to the customer to restore deposited margin to its original level.
12. Customer responds with sufficient additional deposits.
13. Customer places order with futures commission merchant to close out his position, i.e., to enter into a corresponding but opposite contract on his behalf.
14. Futures commission merchant places order with floor broker on floor of exchange.
15. Floor broker executes order on floor of exchange and returns executed trade to futures commission merchant for clearance.
16. Futures commission merchant submits contract to clearing house for clearance, closing out customer's open position.
17. Clearing house releases original margin to futures commission merchant.
18. Futures commission merchant returns all remaining margin on deposit to customer.

The following diagram illustrates this chronology:



This example and the accompanying diagram are in no way intended to be a complete description of a futures transaction, but only an aid in understanding the fundamentals of the functioning of the futures market. There can be many variations to the example. The customer may deal indirectly with the clearing member futures commission merchant through a non-clearing member futures commission merchant. (In such a situation, the customer will deposit margin with the non-clearing member futures commission merchant, the non-clearing member futures commission merchant will deposit margin with the clearing member futures commission merchant, and the clearing member futures commission merchant will deposit margin with the clearing house. The clearing member futures commision merchant must treat both the non-clearing member futures commission merchant's house account and his customers' account as customers' accounts. In addition, the clearing member futures commission merchant must also segregate and separately account for the money, securities, and property of the customers of the non-clearing member futures commission merchant apart from the money, securities, and property of the non-clearing member futures commision merchant.) The customer may, on certain exchanges, place his order directly with a floor broker, instructing him as to what clearing member the contract should be given up to for clearing. The customer may be a floor

broker; or there may be no customer at all, as in the case where the contract is for the house account of the clearing member himself. However, as I have previously indicated, the simplified example set forth above should be adequate to illustrate most of the CFTC's concerns over the bankruptcy of a futures commission merchant, whether the futures commission merchant deals directly with the clearing house or through a carrying futures commission merchant. Where the example is inadequate, appropriate explanations will be given.

FUTURES COMMISSION MERCHANTS—THE HANDLING OF CUSTOMERS' FUNDS AND THE CFTC'S CONCERNS AND RECOMMENDATIONS

Futures Commission Merchants—General Concerns

The CFTC has several basic concerns in the event of the bankruptcy of a futures commission merchant. First, will the trustee in bankruptcy be able to trace or identify the money, securities, and property deposited by commodity customers with the futures commission merchant to margin or secure their trades or contracts? Second, will the trustee grant commodity customers a preference to the money, securities, an property which are identified as those deposited by the customers? Third, if a preference is granted, how will the trustee distribute the identifiable assets? Will he attempt to trace and identify, to the extent possible, each asset to a particular customer, and return that asset to such customer, dividing the remaining assets ratably among all remaining customers with unsettled claims against the futures commission merchant? Or will he simply designate all money, securities, and property traceable or identifiable as belonging to commodity customers in general as a single and separate fund in which the commodity customers of the futures commission merchant share ratably? Fourth, how will the trustee handle the futures commission merchant's open contractual commitments with clearing houses or other futures commission merchants? Will the contracts entered into on behalf of customers be handled differently from those entered into by the futures commission merchant for his own account? Will customer trades be transferred to another futures commission merchant or closed out? How will variation or maintenance margin calls be handled by the trustee? Will the trustee be forced to operate the bankrupt futures commission merchant's business? And for how long a time? And fifth, how will the trustee treat margin deposits and payments made to a clearing house or another futures commission merchant prior to the filing of the petition in bankruptcy? As a bona fide transfer for value or as a voidable preference? The CE Act, as amended by the CFTC Act, and the regulations thereunder provide partial answers to some of these questions; however, an amendment to the Bankruptcy Act appears necessary to resolve the complex problems outlined above which must necessarily confront a trustee in the bankruptcy of a futures commission merchant.

Futures Commission Merchants—General Summary of CFTC Recommendations

In order to resolve the problems outlined above with respect to the bankruptcy of a futures commission merchant, the CFTC recommends that:

1. Commodity customers of a bankrupt futures commission merchant be given a statutory preference to all money, securities, property, open contracts, and other assets which are segregated as belonging to such customers or are otherwise traceable to them;
2. Commodity customers be entitled to share ratably in all such assets;
3. The CFTC be given the power to determine, by rule or regulation, which assets are traceable to commodity customers as a class;
4. Transfers to another futures commission merchant of the open trades or contracts of commodity customers, and the funds margining or securing such trades or contracts, made prior to or within five days of the date of bankruptcy and approved by the CFTC be protected from reversal by the trustee in bankruptcy;
5. Specifically identifiable assets, including open trades or contracts, be traced to individual customers of the bankrupt and returned to them to the extent of each customer's pro rata share or, in the case of open trades or contracts and accompanying margin, either transferred to another futures commission merchant to the extent of each customer's pro rata share or liquidated upon the instruction or inaction of such customer;

6. To the extent the value of specifically identifiable assets, including open trades or contracts, exceeds the value of a customer's pro rata share, he be given the opportunity to deposit sufficient cash to account for the difference and thereby to gain the return or transfer of all such specific assets;

7. The CFTC be given the power to provide by rule or regulation that certain assets, including open trades or contracts, are traceable to a particular customer;

8. The trustee be directed to answer all margin calls on customers' open trades until transfer or liquidation of such trades occurs, but only to the extent of the pro rata share of each such customer;

9. Commodity customers be given a short period of time to file claims and to instruct the trustee as to how to handle their open trades or contracts;

10. All open trades or contracts which are identified to customers, but not transferred to another futures commission merchant, for whatever reason, and all trades or contracts identified to any other person, be liquidated;

11. All variation margin payments made to, and all original margin deposits made with, any clearing house or other futures commission merchant by the bankrupt futures commission merchant prior to the date of bankruptcy, unless made in collusion with such clearing house or such futures commission merchant with the intent of defrauding other creditors of the bankrupt futures commission merchant, be protected from reversal by the trustee in bankruptcy;

12. The CFTC receive notice of, and, on its application, be admitted as a party, to the extent it deems appropriate, in the bankruptcy proceeding.

These recommendations and the reasons therefor are explained at length in the following pages. At the conclusion of this explanation, the CFTC's recommendations are set forth in statutory form along with a brief explanation of the reasons for each provision.

Futures Commissions Merchants—The Protection of Customers in General

The CFTC's first two concerns, whether customer funds in general will be identifiable and whether commodity customers will be entitled to a preference to those assets in the event of the bankruptcy of a futures commission merchant, are closely connected and may be discussed at the same time.

Section 4d(2) of the CE Act, 7 U.S.C. 6d(2), and section 1.20(a) of the regulations thereunder, 17 C.F.R. § 1.20(a), require a futures commission merchant to segregate and separately account for all money, securities, and property received to margin, guarantee, or secure the trades or contracts of commodity customers and all money accruing to such customers as a result of such trades or contracts.[19] This segregation requirement, and the CFTC

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[19] Section 4d of the CE Act provides:

"It shall be unlawful for any person to engage as futures commission merchant in soliciting orders or accepting orders for the purchase or sale of any commodity for future delivery, or involving any contracts of sale of any commodity for future delivery, on or subject to the rules of any contract market unless—

"(1) such person shall have registered under this Act, with the [CFTC] as such futures commission merchant and such registration shall not have expired nor been suspended nor revoked; and

"(2) such person shall, whether a member or nonmember of a contract market, treat and deal with all money, securities, and property received by such person to margin, guarantee, or secure the trades or contracts of any customer of such person, or accruing to such customer as the result of such trades or contracts, as belonging to such customer. Such money, securities, and property shall be separately accounted for and shall not be commingled with the funds of such commission merchant or be used to margin or guarantee the trades or contracts, or to secure or extend the credit, of any customer or person other than the one for whom the same are held: Provided, however, That such money, securities and property * * * may, for convenience, be commingled and deposited in the same account or accounts with any bank or trust company or with the clearing house organization of such contract market, and that such share thereof as in the normal course of business shall be necessary to margin, guarantee, secure, transfer, adjust, or settle the contracts or trades of such customers or resulting market positions, with the clearinghouse organization of such contract market or with any member of such contract market, may be withdrawn and applied to such purposes, including the payment of commissions, brokerage, interest, taxes, storage and other charges, lawfully accruing in connection with such contracts and trades: *Provided, further,* That such money may be invested in obligations of the United States, in general obligations of any State or of any political subdivision thereof, and in obligations fully guaranteed as to principal and interest by the United States, such investments to be made in accordance with such rules and regulations and subject to such conditions as the [CFTC] may prescribe.

"It shall be unlawful for any person, including but not limited to any clearing agency of a contract market and any depository, that has received any money, securities, or property for deposit in a separate account as provided in paragraph (2) of this section, to hold, dispose of or use any such money, securities, or property as belonging to the depositing futures commission merchant or any person other than the customers of such futures commission merchant."

regulations which augment it, determine, to a great extent, the manner in which all futures commission merchants must treat and deal with commodity customers' funds. As a consequence, the handling of customers' funds should not vary significantly from one futures commission merchant to another.

As noted above, when customers deposit margin with a futures commission merchant, whether in money, securities, or property, the futures commission merchant must segregate such customers' funds [20] from his own funds as well as from the funds of any other person and separately account for such customer's funds on, among other things, his own books and records and those of any depository in which he deposits such funds. In general, most futures commission merchants, upon receipt of customers' funds, deposit such funds in a customers' segregated funds account with a bank or trust company. Whenever this is done, regulation 1.20(a) requires that the futures commission merchant deposit such funds "under an account name which will clearly show that they are customers' money, securities, and property, segregated as required by the [CE Act] * * *."

Regulation 1.20(a) further requires that the futures commission merchant obtain and retain in his files an acknowledgment from the bank or trust company that such depository "was informed that the money, securities, and property [in the customers' segregated funds account] are those of commodity customers and are being held in accord with the provisions of the [CE Act]."

After the futures commission merchant has succeeded in having his customers' orders executed on the floor of the appropriate exchange and has had the resulting contracts accepted by the clearing house of the exchange for clearance, the futures commission merchant will be required to deposit margin on those contracts. Assuming that the futures commission merchant, as a clearing member of the exchange, presented his customers' contracts to the clearing house for clearance himself, such margin deposit will have to be made with the clearing house.[21] As previously noted, the futures commission merchant will generally use a portion of the funds deposited with him by his customers to meet this margin call. Customers' funds deposited with the clearing house must still be segregated and separately accounted for pursuant to section 4d(2) of the CE Act and regulation 1.20, by both the futures commission merchant and the clearing house, and are subject to the requirements of regulation 1.20(a) that the funds be deposited under an account name which accurately indicates their character and that the appropriate acknowledgment be obtained regarding the nature of such funds.

It is important at this point to understand the manner in which deposits of original margin with a clearing house by a clearing member futures commission merchant are usually made. The clearing house itself rarely acts as the actual depository of the funds. Instead, the cashier's checks with which original margin deposits must be made are generally made payable to the account of the futures commission merchant himself with a bank or trust company which has been designated as an approved depository for the receipt of original margin by the clearing house. Pursuant to an agreement among the bank, the clearing member futures commission merchant, and the clearing house, the futures commission merchant cannot withdraw funds from this account without the authorization of the clearing house. Of course, the clearing house will not give such authorization until such time as the funds which the futures commission merchant seeks to withdraw are no longer required as margin on the contracts which they secure. In other words, funds serving

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[20] In general, customer deposits of margin are in the form of cash or U. S. Treasury bills. On occasion, other securities and letters of credit are used. To facilitate my discussion, I will use the term "funds" to refer to cash, securities, and all other forms of property. However, when necessary, I will indicate any difference in the handling of customers' securities or property.

[21] If the futures commission merchant must employ the services of a carrying futures commission merchant to clear his customers' trades, he will be required to deposit his customers' funds with that carrying futures commission merchant under an appropriate account name and obtain the required acknowledgment as provided in regulation 1.20(a). In addition, the carrying futures commission merchant must treat and deal with those funds as customers' funds, subject to all the segregation and separate accounting requirements, etc., of the CE Act and the regulations thereunder which are applicable to the account of any other customer.

as original margin for futures contracts will not be released until those contracts have been offset or performance has been rendered thereon.[22]

This is to be contrasted with the way in which variation margin or settlement payments for customers' accounts are treated. These payments are also made by cashier's check drawn on the futures commission merchant's customers' segregated funds bank account; however, since variation margin payments on customers' contracts are payments to account for losses suffered by such customers as the result of adverse price movements in the market, not true deposits, cashier's checks used to meet variation margin calls on customers' accounts are made payable directly to the clearing house. Although a clearing member making variation margin payments for both his customers' and his house accounts must do so with two checks, all such payments are generally deposited into one account by the clearing house. As previously mentioned, because there is an equal and opposite side to each futures contract when it is originally entered into on the floor of the exchange, whenever one person suffers a loss as a result of a price change in the market, there must be another person who has profited from that price change. As a consequence, the clearing house is obligated to make payments to its clearing members whose customers' and house accounts have profited from a price change which correspond exactly to those variation margin payments it receives from its clearing members whose customers' or house account has suffered losses as a result of the price change. Theoretically, then, the clearing house's variation margin bank account should be at zero each night.[23] Due to the nature of the variation margin system, payments into such accounts are not subject to the account name and acknowledgment requirements of regulation 1.20(a).

On the other hand, regulation 1.21 provides that "[a]ll money received directly or indirectly by, and all money and equities accruing to, a futures commission merchant from any clearing organization of any contract market, or from any member thereof or from any member of a contract market, incident to or resulting from any trade or contract in commodity futures made by or through such futures commission merchant in behalf of any customer shall be considered as accruing to such customer within the meaning of section 4d(2) of the Act. Such money and equities shall be treated and dealt with as belonging to such customer in accordance with the provisions of the Act."

Therefore, all variation margin payments made to a futures commission merchant on behalf of his customers by the clearing house are subject to all the requirements of section 4d(2) of the CE Act and regulation 1.20(a) (as are all payments received by the futures commission merchant on behalf of his customers from a carrying futures commission merchant). Consequently, variation margin payments by the clearing house are made with two separate checks, one for the futures commission merchant's customers' account and one for his house account. A futures commission merchant receiving payments on behalf of his customers must deposit such payments into his customers' segregated funds bank account along with the rest of his customers' segregated funds.

There are several additional provisions in CFTC regulations to insure segregation of cusetomers' funds by futures commission merchants. Regulation 1.20 (a) prohibits customers' funds from being obligated to a clearing house, or to any member of a contract market, a futures commission merchant, or any depository, except to margin trades or contracts made on behalf of such customers. That regulation further prohibits customers' funds from being "held, disposed of, or used as belonging to the depositing futures commission merchant

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[22] In addition, the clearing house itself generally has the right to withdraw customers' funds under certain circumstances, such as the failure of the futures commission merchant to make variation margin payments for its customers' account when called upon to do so by the clearing house.

Some clearing houses do require original margin deposits to be made directly with them. In such instances, however, the clearing house will deposit the cashier's checks made out to its own order in special bank accounts, segregated where required. As with other clearing houses, original margin is not released until offset or performance.

[23] However, because drafts or checks drawn on the account are not always presented for payment immediately, a substantial balance often exists in such an account.

or any person other than the customers of such futures commission merchant." Regulation 1.32 requires each futures commission merchant to make and keep a daily computation of the amount of money, securities, and property which must be segregated in order to comply with the requirements of section 4d(2) of the CE Act. And regulations 1.33 and 1.36(a) require the futures commission merchant to make and keep records of all securities and property received from customers to margin their trades or contracts.

If the CFTC could require and insure strict compliance with the above segregation and separate accounting requirements on the part of all futures commission merchants, its first concern in the event of the bankruptcy of a futures commission merchant would be obviated. A trustee in bankruptcy could easily trace all money, securities, and property deposited as margin by commodity customers, and all money accruing to such customers as a result of their trades or contracts, to the funds segregated by the futures commission merchants on behalf of such customers. However, it is impossible for the CFTC to insure that each futures commission merchant will be in constant compliance with its segregation and separate accounting requirements, despite an extensive audit and inspection program. Furthermore, due to the basic nature of the futures industry and to the fact that securities and property can be deposited by customers as margin in lieu of cash, it is not always possible to require that the cash deposited by commodity customers be strictly segregated from that of their futures commission merchants.

Even if strict segregation could be required and enforced, this would not eliminate the need for the creation of a specific statutory preference in favor of the commodity customers of a bankrupt futures commission merchant. The fact that strict segregation can be neither insured nor required only accents the need for such a statutory preference. As previously alluded to, there are no appellate court interpretations of the Bankruptcy Act upon which a trustee in bankruptcy may draw to determine how the customers of a bankrupt futures commission merchant should be treated in the event of his bankruptcy. Specifically, there are no appellate court decisions on whether commodity customers will be entitled to a preference to the funds they have deposited as margin with the bankrupt futures commission merchant, even if those funds are segregated in accordance with the CE Act and the regulations thereunder. This raises a fundamental question: will segregation, even if strictly adhered to, serve to protect commodity customers in the event of the bankruptcy of a futures commission merchant?

In the past, the CFTC and its predecessor agencies have urged that the bankrupt futures commission merchant be treated as a trustee of the funds deposited by his customers to margin their accounts. Under such an approach, the futures commission merchant, and consequently his trustee in bankruptcy, has no ownership interest in customers' funds deposited as margin on their accounts. Therefore, to the extent such funds can be traced and identified, they can be reclaimed by the futures commission merchant's customers. To date, trustees in the bankruptcies of futures commission merchants have awarded commodity customers a preference to funds in segregation; however, the theory under which this has been done is unclear. Such preferences seem to be the result of either an adaptation of traditional trust law to a commodity futures industry bankruptcy or an application of the law governing the bankruptcies of securities broker/dealers prior to 1938, the year section 60e of the Bankruptcy Act took effect. In some cases, it may be a combination of the two approaches. Both approaches appear ill-suited to the bankruptcy of a futures commission merchant. What is most important, however, is that there is no clear statement of the law in this area; there is no case, or combination of cases, which sets forth an acceptable approach to the problem of futures commission merchant bankruptcies. The only cases in this area have resulted in vague decisions which award or disallow preferences without a clear explanation as to why. And none of these decisions has been tested at the appellate court level.

Where the funds of the commodity customers of a futures commission merchant suffering bankruptcy are not in actual segregation at the time of the

bankruptcy,[24] it is likely that such funds, whether traceable to customers or not, will become subject to the claims of the general creditors of the bankrupt. While trustees in the bankruptcies of futures commission merchants have generally awarded commodity customers a preference to funds in segregation, they have not generally granted such customers a preference to nonsegregated funds, even where such funds are readily traceable back to customers.

Since the theory upon which trustees in bankruptcy have awarded customers a preference to segregated funds is itself unclear, the theory upon which customers could be granted a preference to nonsegregated funds is even more unclear. It may be possible to argue successfully, for example, that customers' funds which are not properly segregated by a bankrupt futures commission merchant have been fraudulently converted by him and and that therefore, to the extent such nonsegregated funds can be traced to customers, a constructive trust should be imposed upon such nonsegregated funds for the benefit of those customers. However, unless such funds are readily traceable to the futures commission merchant's customers, this or any similar argument, even if successfully made, may prove fruitless. Furthermore, absent well-defined guidelines as to the application of such theories, each trustee in the bankruptcy of a futures commission merchant is likely to apply the tracing process in a different way, resulting in a wide variety of nonsegregated assets being included within the corpus of the constructive trust. It is highly doubtful that this process of random decisions would result in uniform standards of protection for commodity customers.

Assuming that a bankrupt futures commision merchant has complied with all the segregation requirements of the CFTC, there is still an additional factor which casts further doubt on the ability of commodity customers to recover their margin deposits and futures trading profits from the trustee in the bankruptcy of a futures commission merchant. Traditional trust law requires the trustee to segregate the corpus of the trust he administers from his own assets at all times. However, it is not possible to maintain strict segregation in the futures market system in all instances and, hence, the CE Act and CFTC regulations permit house funds to be commingled with customers' funds in certain situations. As a result, general creditors of the bankrupt futures commission merchant might be able to argue successfully that the bankrupt futures commission merchant did not hold commodity customers' funds in trust for such customers in any traditional sense and that therefore no preference should be allowed.

An example of permissible commingling of house and customers' funds has already been discussed. A clearing house is simply unable to segregate customers' and house variation margin payments. On any given day there will be funds in the variation margin or settlement account of a clearing house paid in by futures commission merchants and customers against whom the market has moved and owing to futures commission merchants and customers who have profited from the move in the market. It might be possible to segregate variation margin paid in on behalf of customers from that paid in by clearing members on proprietary or house accounts, but at what point does the character of such funds change, in other words, at what point do certain funds become funds owing to customers and other funds become funds owing to clearing members on their house accounts? And which funds become owing to

[24] The impossibility of insuring that each futures commission merchant will comply with the CFTC's segregation requirements at all times is self-evident. There is always the possibility that a futures commission merchant will "dip into" customers' segregated funds and misappropriate those funds for his own use. This is especially true where the futures commission merchant is experiencing financial difficulty. In addition, a futures commission merchant may simply fail to segregate customers' funds without actually misappropriating them. This may occur through inadvertence or through inadequate self-monitoring systems utilized in an attempt to reduce costs. Again, it is the futures commission merchant experiencing financial difficulties who will be more likely to utilize such inadequate cost-saving internal systems. The CFTC is currently developing a sophisticated early warning system to alert it to the financial difficulties of any futures commission merchant. Such early warnings will enable the CFTC to monitor closely the transactions of such futures commission merchants. However, even with this system, there will still be no way to guarantee that violations of the CFTC's segregation requirements will not occur where such violations occur prior to the early warning signal or where the futures commission merchant does not comply with the early warning requirement.

whom? Each day either customers in general will have profited from the movement of the market that day and clearing members in general, trading for their own accounts, will have suffered losses, or vice versa. If this is this case, as it most probably is on any given day, funds paid in on behalf of customers suffering losses as a result of the movement of the market will not be exactly equal to those occurring to customers profiting from the movement of the market. In this instance, then, due to the nature of the futures market system, strict segregation of customers' funds apart from house funds is impossible.

This permissible commingling of the funds of commodity customers with those of futures commission merchants at the clearing house level is relatively unimportant, however, due to the zero-sum nature of the variation margin system. Whatever is paid into the clearing house in variation margin should theoretically be paid out the same day. On the other hand, at the futures commission merchant level, where the majority of all funds deposited by commodity customers are maintained, commingling of the funds of futures commission merchants with those of their customers may involve hundreds of millions of dollars in customers' funds. Yet even here, the nature of the futures industry prevents the imposition of a segregation requirement which strictly prohibits any commingling of the funds of a futures commission merchant with those of his commodity customers. The most critical instance in which this is the case involves the deposit by commodity customers of securities in lieu of cash with their futures commission merchant as margin on their accounts. This is permitted by both the CE Act and CFTC regulations; however, due to the nature of the clearing house system, it presents major obstacles to the effective segregation of customers' funds from those of the futures commission merchant. A detailed and lengthy explanation of the clearing house system is, unfortunately, necessary to illustrate the problems presented by the deposit of securities as margin in lieu of cash. With your indulgence, I will undertake such an explanation at this time.

Clearing houses make margin calls, both original and variation, on a net basis in both accounts carried by a clearing member, i.e., in both his house account and his customers' account. This is to be distinguished from a clearing house determining the amount of an original or variation margin call through a net system. Even original margin calls determined through a gross system are made on a net basis. A simple example will clarify the distinction and illustrate what is meant by margin calls on a net basis.

Assume a futures commission merchant with ten customers. Five of those customers each place and have executed orders to buy two contracts of December '76 silver and five place and have executed orders to sell one contract of December '76 silver. The clearing house to whom these trades are presented for clarance by the futures commission merchant will determine the original margin required to secure those trades through a gross or a net system. If it employs a gross system, it will require the futures commission merchant to deposit original margin on 15 open contracts (10 buys plus 5 sells). If it employs a net system to determine original margin, it will require original margin (usually a greater amount per contract) on a net long position of five contracts (10 buys minus 5 sells).

Number of contracts on which original margin required:	*Number of contracts on which margin call made*
Gross system: 10 buys plus 5 sells=15 open contracts	15
Net system: 10 buys minus 5 sells=5 buy contracts	5

Assume further that on the next day nine of these customers each place and have executed orders to buy one additional contract of December '76 silver, four of the five customers who previously sold December '76 silver thereby closing out their positions. The clearing house employing the gross system in determining original margin calls would be notified by its clearing member futures commission merchant that four of the nine new buys were to be used to close out old sells, i.e., that these trades were for liquidation. The clearing house would then require original margin to be deposited by the futures commission merchant on behalf of the five new buy contracts which were not used to close out sell contracts from the day before, and would release the margin deposited the day before to secure the four sell contracts closed out that day. However, the clearing house would make its original margin call to the futures commission merchant on a net basis; in other words, it would offset the original margin required on the five new buy contracts against the original margin released on the four old sell contracts closed out that day. As a result,

the clearing house using the gross system to determine original margin calls would make an original margin call on only one contract. The clearing house using the net system to determine original margin calls would simply add nine new buy contracts to the previous open net position in the futures commission merchant's customers' account (five buy contracts) to arrive at the number of contracts for which margin must be on deposit for such account, a total of 14. Since the futures commission merchant would only have deposited original margin on five contracts the day before, the clearing house will require an additional original margin deposit to cover nine other contracts. The net original margin call would also be for nine contracts.

Number of contracts on which original margin required:	*Number of contracts on which margin call made*
Gross system: 10 open buys plus 5 open sells (total=15) plus 5 open buys minus 4 buys for liquidation=16 open contracts	16−15=1
Net system: 5 buy contracts plus 9 buy contracts=14 buy contracts	14−5=9

Finally, assume also that on this second day of trading five other customers of the futures commission merchant add five sell contracts to a net open position of ten open buy contracts of May '77 silver, thereby closing out five of the ten open buy contracts. Under both the gross and the net systems this would mean that original margin would be required on only five contracts of May '77 silver and would necessitate the release of the original margin securing five such contracts. When the clearing house using the gross system makes its original margin call on a net basis to the futures commission merchant, it will offset the original margin deposit required on the one additional open contract in December '76 silver with the original margin released on one of the five closed out buy contracts in May '77 silver and release original margin on the other four May '77 silver contracts closed out that day. When the clearing house using the net system makes its original margin call on a net basis to the futures commission merchant, it will offset the original margin deposit required on five of the nine new buy contracts in the open position in the futures commission merchant's customers' account in December '76 silver with the original margin released on the five contract reduction in the net open position in that account in May '77 silver and make a net original margin call for a deposit to secure four contracts only.[25]

Further explanation of the futures industry and the CE Act and the regulations thereunder will demonstrate how the making of margin calls on a net basis necessitates permissible commingling of the funds of commodity customers with those of the futures commission merchants. Section 4d(2) of the CE Act prohibits a futures commission merchant from using the funds of one customer to margin the trades of any other person, including any other customer of the futures commission merchant. Regulation 1.22 implements this statutory provision by prohibiting a futures commission merchant from using or permitting the use of "the money, securities, or property of one customer to margin or settle the trades or contracts * * * of any person other than such customer." Regulation 1.22 further implements section 4d(2) of the CE Act by prohibiting any person, including any clearing house, from using the net equity of one customer to carry the trades or contracts or to offset the net deficit of any other customer or person.

As previously discussed, when a futures commission merchant is called upon to deposit original or variation margin with a clearing house to secure contracts entered into on behalf of a customer, he will normally use the funds deposited with him by the customer to meet such margin calls. For example, assume customer A's trades necessitate the deposit of $500 and customer B's trades necessitate the deposit of $1,000 in original margin with the clearing house. In order to carry A's and B's trades, a futures commission merchant would be likely to require, for example, $1,500 in margin deposits from A and $3,000 from B, a portion of which he would in turn use to margin the trades of A and B with the clearing house. The futures commission merchant's books would then show $1,500 owing to A, $500 on deposit with the clearing house and $1,000 in the futures commission merchant's customers' segregated funds bank account, and 3,000 owing to B, $1,000 with the clearing house and $2,000 in the customers'

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[25] The handling of variation margin calls, determined through a net system as well as made on a net basis by all clearing houses, is analagous to the example of the clearing house which determine original margin calls through a net system. The net open position in each contract is simply multiplied by the change in settlement price. See above.

segregated funds account. When variation margin calls are made on either A's or B's contracts, the futures commission merchant can use the funds of such customers still on deposit with him to meet such calls.

As I described above, the clearing house may offset A's losses against B's gains in making variation margin calls to the futures commission merchant; or it may use money originally deposited as original margin on contracts of B, which have since been closed out, to margin the new trades of A. This would appear to violate regulation 1.22; however, since money is 100 per cent fungible, a netting out at the clearing house level of one customer's new contracts (or losses) against the closing out of another customer's old contracts (or his profits) can be offset at the futures commission merchant level without any violation of regulation 1.22. A simple book transfer is all that's necessary. The futures commission merchant need merely offset the margin calls made on a net basis by the clearing house by making appropriate adjustments to the interests of A and B in the futures commission merchant's customers' segregated funds bank account, as reflected on his own books and records.

However, assume that instead of depositing cash to margin his trades, customer A deposits $1,500 in securities. Since securities, even U. S. Treasury bills, are not 100 percent fungible, a book transfer at the futures commission merchant level cannot serve to offset the use of one customer's securities or cash at the clearing house level to margin the trades of another customer. As a result, the net basis upon which clearing houses make margin calls and releases of original margin or payments of variation margin maks it impossible for them to accept customer securities as margin without violating section 4d(2) of the CE Act and regulation 1.22 thereunder. Furthermore, since a clearing house deals only with its clearing members, it does not know the specific customer on whose behalf a particular contract was entered into by one of its clearing members. And, although CFTC regulation 1.36(a) does require a futures commission merchant to obtain an acknowledgment from any clearing house with which the futures commission merchant is able to deposit customer securities that such clearing house was informed those securities belong to a particular customer, the clearing house would not, in general, know who that particular customer is. As a result, the clearing house would have no way of knowing which contracts are to be margined by which securities and, hence, under the present clearing house system, no way to insure against an unwitting violation of section 4d(2) of the CE Act and regulation 1.22 thereunder.[26]

It is conceivable that the amount owed by a clearing member to the clearing house in original and variation margin with respect to each customer could be ascertained through a sophisticated computerized system which incorporates individualized margin calls to clearing members on behalf of each of their customers. Such a system might also be programmed to match each contract to the security or securities deposited to margin that contract. However, the implementation of such a system would necessitate extensive and basic changes in the present clearing house system, eventually resulting in a dramatic increase in the cost of each futures transaction. The CFTC believes that the effect of such a major transaction cost increase would be to dissuade many small hedgers and speculators from entering the futures markets at all. The liquidity of the markets would in turn be significantly reduced, eventually resulting in the collapse of many of today's futures markets. The CFTC believes such a result, with the corresponding destruction of a significant portion of the vital hedging mechanism [27] provided by the futures markets, is totally unacceptable. Moreover, assuming that such an individualized margin system could be implemented, it would still be impossible for the clearing house to accept customer securities as variation margin payments. The very nature of such payments makes this so. The exact amount of any variation margin call with respect to a particular customer will undoubtedly differ from a multiple of the unit market value of the securities deposited by that customer. Since variation margin payments are precisely that, payments, there can be no question of excess deposits, because the clearing house pays out everything it

[26] As will be explained later, the possibility that a trustee in the bankruptcy of a futures commission merchant may use a strict tracing approach to distribute commodity customers' funds prevents any interpretation of section 4d(2) of the CE Act, and a corresponding amendment of CFTC regulation 1.22, to permit a clearing house to use to net equity in the securities deposited on behalf of one customer to margin or secure the trades of another.

[27] See page 62 for discussion of the term "hedging."

takes in. Furthermore, there is little likelihood the amounts paid in by customers A, B, and C, for example, will correspond precisely with those owing to customers X, Y, and Z. The only workable alternative would be for the clearing house to liquidate the securities and use the proceeds to pay X, Y, and Z, again at added expense to the clearing house. As a result, variation margin payments must necessarily be made in cash.

Since clearing houses are unable to accept customer securities as margin, futures commission merchants would also be unable to accept such securities from their customers as margin, unless the CE Act and CFTC regulations permitted them to use some other source of funds to margin the trades of such customers. Even if customer securities were accepted by clearing houses as original margin, futures commission merchants would still be unable to accept securities alone as margin for their customers' trades due to the problems described above in meeting variation margin calls which differ from multiples of the unit value of the deposited securities. (In addition, since variation payments, once made, are gone for good, a customer will generally look with disfavor upon the futures commission merchant's use of his securities to meet variation margin calls.)

As noted above, a futures commission merchant who accepts customer securities as margin in lieu of cash must employ another source of funds to meet clearing house margin calls with respect to the trades of such customers. Assuming that the segregation requirements of the CE Act and CFTC regulations did not permit the futures commission merchant to use his own funds to margin the trades of such customers, the only source from which such margin deposits might be made would be the cash deposited by other customers. However, section 4d(2) of the CE Act and CFTC regulation 1.22 specifically prohibit a futures commission merchant from using the funds of one customer to margin the trades or contracts of another. This prohibition, aside from being specifically provided for in the CE Act, appears to be necessary to insure that each customer of a futures commission merchant receives something which at least approaches fair or equal treatment in the event of the bankruptcy of the futures commission merchant. Without it, customers depositing securities as margin (generally, large spectators and industrial hedgers) may receive 100 per cent of their margin deposits back from the trustee in bankruptcy under a strict, specifically identifiable asset tracing test, whereas those customers who deposit cash for margin (generally, smaller customers, such as a small farmer or a member of the general public speculating in the markets) may receive a much smaller return, proportionally, of the funds deposited by them with the futures commission merchant to margin their accounts.

The possibility of such unequal treatment arises where a large customer of the futures commission merchant becomes insolvent and is unable to meet the margin calls of the futures commission merchant, who in turn, becomes unable to meet the variation margin calls of the clearing house with respect to such customer's trades or contracts. When the futures commission merchant fails to answer its variation margin calls, the clearing house will use the original margin deposits in the futures commission merchant's customers' account to meet its variation margin calls. If the futures commission merchant has used the cash deposited by cash customers to margin not only their trades or contracts but also those of customers who have deposited securities as margin in lieu of cash, the only money in the futures commission merchant's customers' original margin account with the clearing house will be the cash deposited by cash customers. Upon the bankruptcy of the futures commission merchant, there will be little more than securities on deposit in the futures commission merchant's customers' account at the futures commission merchant level. These securities can be traced to the particular customers who deposited them and, under a strict tracing approach, will be returned to such customers. The cash deposited by cash customers will have been used to meet variation margin calls by the clearing house. Due to the nature of the clearing house system, which permits a clearing house to use whatever funds are on deposit with it on behalf of customers to meet variation margin calls with respect to customers' trades or contracts, and to the lack of contractual privity between the clearing house and the commodity customers of the clearing house's members, cash customers may well have no recourse against the clearing house. Since both the large, under-margined customer and the futures commission merchant are bankrupt, it is of little use for cash customers to look at them for their moneys. And it is highly doubtful that current law would give cash

customers any recourse against the customers who deposited securities in lieu of cash. As a result, cash customers would lose almost all their margin money, while customers depositing securities in lieu of cash get almost everything back.[28]

As discussed above, there are a great many obstacles to a futures commission merchant accepting customer securities as margin deposits. On the other hand, customers, especially large hedgers, exert a great deal of pressure on futures commission merchants to accept securities as margin. By depositing securities as margin in lieu of cash, large hedgers are able to reduce the cost of their hedging operations by the interest which accrues on their securities. Many large traders regularly keep large amounts of money in securities for the express purpose of meeting margin requirements. The pressure exerted on futures commission merchants to accept securities as margin is even greater where the international commodities are involved, such as gold and silver, because foreign futures commission merchants accepting orders on foreign exchanges, to whom CFTC segregation requirements do not apply, can and do accept securities from customers as margin in lieu of cash.

There are three things which might be done to permit futures commission merchants to accept securities as margin in lieu of cash. The first, changing the entire clearing house system by imposing on the futures industry an extremely expensive, individualized gross margin system, is impractical. The second choice, permitting a futures commission merchant to use the securities or cash of one customer to margin the trades or contracts of another, besides being specifically prohibited by the CE Act, is subject to substantial abuse and open up the possibility that customers who make margin deposits in cash will be at a severe disadvantage in the event of the bankruptcy of their futures commission merchant. The third possibility, permitting a futures commission merchant to use his own funds to margin or secure the trades or contracts of customers depositing securities in lieu of cash as margin, appears the only viable alternative even though it necessitates the commingling of house and customers' funds. Such permissible commingling is provided for in regulations 1.23 and 1.30.

Regulation 1.23 construes the prohibition against commingling in section 4d(2) of the CE Act so as to permit a futures commission merchant to add "to customers' segregated funds from his own funds such amount or amounts of money as he may deem necessary to insure any and all customers' accounts from becoming undermargined at any time: Provided, however, That the books and records of such futures commission merchant shall at all times accurately reflect his interest in customers' segregated funds."

Regulation 1.23 also permits a futures commission merchant to "draw upon such segregated funds to his own order to the extent of his actual interest therein: Provided, That such withdrawal shall not result in the money, securities, property, or equity of one customer being used to margin or carry the trades or contracts, or extend the credit, of any other customer or person."

Regulation 1.30 permits a futures commission merchant to lend "his own funds to commodity customers on securities and property pledged by such customers, * * * [and and repledge or sell] such securities and property pursuant to specigc written agreement with such customers: Provided, however, That the proceeds of such loans used to margin, guarantee, or secure the trades or contracts of such customers in any commodity for future delivery shall be treated and dealt with such such futures commission merchant as belonging to such customers, in accordance with and subject to the provisions of section 4d(2) of the Act."

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[28] A similar result would be possible if section 4d(2) of the CE Act were interpreted, and regulation 1.22 were accordingly amended, to permit a clearing house to use the net equity in the securities deposited on behalf of one customer to margin or secure the trades or contracts of another. This might be the result of the following scenario. Assume a futures commission merchant with only two customers, A and B. Assume further that the futures commission merchant deposit B's securities with the clearing house to margin not only B's trades but those of A, a cash customer, as well. Finally, assume that the futures commission merchant fails to segregate A's cash margin deposits and that they cannot be traced or identified to the futures commission merchant's commodity customers upon his bankruptcy. Under a strict tracing approach, B would recover the securities he deposited as margin in full while A, forced to claim as a general creditor, would undoubtedly recover very little. If on the other hand, the futures commission merchant had been required to and did deposit a portion of A's cash margin deposits with the clearing house to margin A's trades, A might at least be able to recover that portion of his cash margin deposits.

These regulations eliminate, at least to some extent, the problems discussed above.[29] The futures commission merchant can either loan the customer his own funds to margin the customer's contracts or, as is much more likely, he can add enough of his own funds to customers' segregated funds to insure that no customer's contracts will become undermargined. The futures commission merchant can then use the cash he has so added to customers' segregated funds, as he would customers' funds themselves, to meet clearing house original and variation margin calls.

As a result of this permissible commingling of the funds of commodity customers with those of the futures commission merchant, however, it may be much more difficult for a trustee in bankruptcy to trace or identify customers' money, securities, and property in the event of the bankruptcy of the futures commission merchant. More importantly, this permissible commingling of house funds with customers' funds, as well as other provisions of the CFTC's regulations,[30] may result in a finding by a trustee in the bankruptcy of a futures commission merchant that the bankrupt futures commission merchant did not hold the funds of his commodity customers in trust for such customers and that therefore commodity customers should not be given a preference to customers' funds with which the funds of the futures commission merchant have been commingled. Customers' funds would then become subject to the claims of the futures commission merchant's general creditors, with commodity customers realizing a correspondingly lower percentage return of their margin deposits in the bankruptcy.

In order to alleviate the problems discussed above, the CFTC recommends that:

1. commodity customers of a bankrupt futures commission merchant be given a statutory preference to all funds segregated as belonging to such customers or otherwise traceable to them;
2. the CFTC be given the power to determine, by rule or regulation, which assets are traceable to such commodity customers in general; and
3. commodity customers be entitled to share ratably in funds traceable to such customers as a class.

These provisions would insure that commodity customers would receive adequate protection in the bankruptcy of a futures commission merchant without unfairly prejudicing the claims of the general creditors of the bankrupt futures commission merchant. They should also enable the CFTC to resolve any tracing problems which might develop in the applicationof such a preference, not in a case-by-case or quasi-judicial manner, but rather in a quasi-legislative fashion addressed to prospective cases only. Moreover, they would enable the CFTC to insure that commodity customers receive uniform protection in the bankruptcies of futures commission merchants without intruding unnecessarily into the function of the judiciary. Finally, they would enable to CFTC to restructure its segregation requirements so that customer securities could be deposited with clearing houses as margin without disrupting the present clearing procedures in the futures market system.

Futures Commission Merchants—The Distribution of Customers' Funds and the Handling of Open Contracts

Once a trustee in the bankruptcy of a futures commission merchant has identified certain assets as those of the futures commission merchant's customers and awarded those customers a general preference to such identifiable

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[29] In the example given in the text, customers depositing securities as margin will still be in a better position in the event of the bankruptcy of the futures commission merchant than cash customers; however, such cash customers will only lose so much of their funds via the use of original margin by the clearing house to meet variation margin calls resulting from the large trader's market position as was on deposit with the clearing house to margin their own trades or contracts.

[30] Section 4d(2) of the Act and regulation 1.25 permit a futures commission merchant to invest customer's funds in certain specified securities (those guaranteed by a governmental unit). Such investments must be made pursuant to the strict requirements of regulations 1.26 through 1.29, which, among other things, require that such securities be segregated as belonging to the futures commission merchant's customers and that the details of each such investment, including the eventual disbursement of its proceeds back into customers' segregated funds accounts, be recorded in the futures commission merchant's books and records. Regulation 1.29 does permit the futures commission merchant to retain all profits on such investments for himself, however, in contrast to traditional trust law.

assets, there are two significant problems which must still be resolved. How will the assets to which customers have been awarded a general preference actually be distributed? And how will the trustee handle the bankrupt futures commission merchant's open contractual commitments with clearing houses and other futures commission merchants? In particular, how will open futures contracts entered into by the bankrupt futures commission merchant on behalf of his customers be dealt with by the trustees? These represent the CFTC's third and fourth concerns in the event of the bankruptcy of a futures commission merchant. As with the CFTC's first two concerns, these two areas of concern are closely related and are best discussed concurrently.

There are four types of assets which can be traced and identified as belonging to commodity customers in general in the bankruptcy of a futures commission merchant: cash deposited by customers to margin their accounts which is still in the form of cash; cash deposited by customers to margin their accounts which has been invested in securities pursuant to CFTC regulation 1.25; securities and property deposited by customers to margin their accounts; and open futures contracts, or contractual commitments. entered into by the bankrupt futures commission merchant on behalf of his customers. In addition, segregated funds might also include the funds of the futures commission merchant added to customers' funds to margin customers' trades or contracts pursuant to CFTC regulation 1.23. There are, then, five assets with which the CFTC is primarily concerned in the event of the bankruptcy of a futures commission merchant. Assuming the futures commission merchant has complied with the segregation requirements of the CE Act and CFTC regulations, these assets will generally be located in one of three places. Cash, securities, and property may be either on deposit with the clearing house or its correspondent bank, or in the bankrupt futures commission merchant's own customers' segregated funds bank accounts. Customers' trades or contracts will either be held by the bankrupt futures commission merchant on behalf of his customers directly with the clearing house or through a carrying futures commission merchant.

The primary issue which must be addressed is what should be done with the open contracts entered into by the bankrupt futures commission merchant on behalf of his customers. In many instances such contracts will be those of hedgers rather than investors or speculators.

Hedging is a form of price insurance. A producer, for example, who is long, or owns, a given quantity of a physical commodity and who anticipates selling that commodity at some point in the future, can protect himself against a decline in the price of that commodity by selling futures contracts in that commodity. This would not be an actual sale of his physical commodities, nor would the producer normally expect to deliver his physical commodities in satisfaction of his short futures contract. Rather, since a short position in the futures market will result in a profit if the market price declines and since futures prices generally parallel cash market prices, any losses the producer might suffer in the cash market from a decline in the price of his commodity would be offset by a corresponding profit in the futures market. Similarly, a processor, for example, who will need a certain quantity of a commodity for his business at some future date, can protect himself from an increase in the price of that commodity by buying an appropriate number of futures contracts in that commodity.

As can be seen, hedging can be and is an extremely valuable and essential economic tool. It is, in fact, one of the primary justifications for the very existence of the futures market system. However, in order for the hedging mechanism to work, the integrity of futures contracts must be beyond question, and hedgers must be able to keep their futures positions open as long as their cash positions are open and to close out their futures positions as soon as they close out their cash positions. If hedgers do not have this ability, they will become exposed to the adverse price movements the hedging mechanism is designed to protect against. Therefore, in the event of the bankruptcy of a futures commission merchant, the treatment of the open contracts entered into by the futures commission merchant on behalf of his customers must, to the greatest extent possible, proteect the integrity of each futures contract and permit customers to exercise continuous control over their own positions.

An explanation of the way in which the contracts of customers of financially troubled futures commission merchants have been dealt with historically is

necessary at this point. The commodity exchanges themselves, rather than trustees or receivers in bankruptcy, have been the primary factor in determining how open futures contracts made on behalf of customers are dealt with.

Contract markets and their clearing houses, in general, maintain close surveillance over their clearing members. If a clearing member is unable to meet a margin call, the clearing house and the exchange are, obviously, alerted to the financial problems of that member. In addition, should market movements result in substantial losses to a clearing member on any given day, the clearing house and the exchange subject that member to especially close scrutiny. Finally, some contract markets have detailed financial requirements of their own apart from those of the CFTC. If an exchange and its clearing house have any reason to believe that a clearing member can no longer meet their minimum financial requirements, they generally subject that member to a closer examination to determine if there is any basis for their belief.

Once a contract market and its clearing house have determined that a clearing member's financial condition is such that he can no longer be permitted to act as a clearing member without jeopardizing his customers or the other clearing members of the exchange, the contract market and its clearing house initiate action to deal with the clearing member's open contracts. This action generally begins with a meeting between officials of the contract market and its clearing house and the failing clearing member to determine what should be done with the failing futures commission merchant's open contracts. The contracts entered into by the failing futures commission merchant for his proprietary or house account are always closed out. However, customers' open contracts, and the margin deposits thereon, may be transferred to a financially stable clearing member futures commission merchant. This is usually accomplished by transferring all customer contracts and margin deposits to a single futures commission merchant; however, if the failing futures commission is a very large firm, his customers' trades will normally be divided among several stable futures commission merchants. (If the financial position of the failing futures commission merchant is sufficiently stable once his own positions have been closed out, his customers may be consulted in order to determine which other futures commission merchant they wish their trades and margin deposits transferred to before such transfer is actually made; but in no case will the delay in transfer ever extend beyond 2 or 3 days.) Such transfers are generally made only with respect to customer trades which are adequately margined with both the clearing house and the failing futures commission merchant. Customer trades which are not transferred to another futures commission merchant are closed out just as the failing futures commission merchant's proprietary trades were closed out.

There are two main problems with this procedure. The first is that there is a possibility such transfers might be set aside by the trustee in bankruptcy. The second lies in the fact that where a failing futures commission merchant has failed to segregate customers' funds or has converted customers' funds to his own use in violation of the CE Act and CFTC regulations, there will generally be no transfer of customers' open contracts because there will not be enough funds in segregation to margin those contracts. To date, where the amount of undersegregation has amounted to only a few thousand dollars, some of the larger futures commission merchants have occasionally accepted a failing futures commission merchant's customers trades and absorbed any resulting loss themselves for the "good of the industry." However, there is no obligation on the part of other futures commission merchants to do this; and it has not become a standard practice. Furthermore, it can be assumed that no futures commission merchant would be willing to accept such customers' trades where the amount of undersegregation is tens or hundreds of thousands of dollars.

Where no transfer is made, the trades are closed out. Where customers' trades are closed out involuntarily, the hedging mechanism breaks down and hedgers are once again exposed to price risk. Although customers are notified immediately when an exchange is forced to close out the open contracts of their futures commission merchant, this frequently does such customers little good because the margin money which would normally be released to the futures commission merchant and made immediately available to customers upon the close out of their open contracts, and any other margin deposits or accrued profits on deposit with the failing futures commission merchant, are

not released to those customers until the trustee in the bankruptcy of the futures commission merchant makes a distribution of segregated funds. At best, such a distribution will take weeks. At worst, it could take months or years. While this is costly to speculative investors who lose the use of their money until it is distributed, it may prove disastrous to hedgers. When a hedger is notified that his position is being closed out by the exchange, it would cause him relatively little concern if he is in a position to re-enter the futures market and re-establish his hedging position. He would remain protected from the risk of price change. However, it is frequently the case that a hedger will have such a substantial portion of his capital tied up in his cash inventory or his processing operations and on deposit with the bankrupt futures commission merchant to margin his original hedging position, that he will be unable to deposit the amount of margin required to open a new futures hedging position. As a result, until his margin deposits, etc., are returned by the trustee in bankruptcy or until he is otherwise able to raise sufficient margin, such a hedger will be unhedged and exposed to the risk of adverse price changes. As previously noteed, the hedger may not receive his margin deposits back for several weeks or months; therefore, the hedging mechanism with respect to such hedgers is destroyed.

When the failing futures commission merchant is not a clearing member of an exchange, most exchange's conduct little, if any, surveillance over his financial status. If the futures commission merchant is a non-clearing member of the exchange, the exchange is likely to impose some minimal financial requirement upon the member to insure the integrity of any contracts he might execute on the floor of the exchange in his capacity as a floor broker; however, such requirements are not designed to protect the customers of such a non-clearing member in his capacity as a futures commission merchant nor would exchange review of his financial condition be directed at such protection. The requirements of only two exchanges are designed to provide this latter type of protection. If the failing futures commission merchant is not a member of an exchange, the exchange imposes no financial requirements upon him and has little authority to do so. As a result, industry, as opposed to CFTC, detection of a non-member futures commission merchant's financial problems will generally be made by the clearing member futures commission merchants who clear his trades, i.e., his carrying futures commission merchants.

As previously noted, futures commission merchants who clear customers' and proprietary trades through a carrying futures commission merchant are required to maintain a separate account with the carrying futures commission merchant for customers' trades and funds. Consequently, non-member futures commission merchants will normally maintain two accounts with a carrying futures commission merchant, a customers' account and a house omnibus account through which the non-member futures commission merchant clears his own trades. A carrying futures commission merchant generally learns that a non-member futures commission merchant is experiencing financial difficulty only when the non-member futures commission merchant fails to answer a margin call of the carrying broker. The margin call which the non-member futures commission merchant usually fails to answer is that made with respect to his house omnibus account. When this occurs, the carrying futures commission merchant is generally required under exchange rules to close out as much of the non-member futures commission merchant's positions as is necessary to restore his account to an adequately margined status. The carrying broker will not, however, close out the non-member futures commission merchant's customers' contracts unless margin calls on those contracts are not met as well; and, of course, the carrying broker cannot force that futures commission merchant to transfer his customers' trades to anoteher firm.

Because of this procedure, it is quite likely that a trustee in the non-member futures commission merchant's bankruptcy will find many open customer contracts among the assets to be distributed by him. If the truseee orders these contracts closed out and withholds distribution of the funds deposited by customers to margin their contracts, many hedgers will find themselves exposed to the risk of adverse price changes. The hedging mechanism will once again have broken down. In addition, due to the fact that intervention into the business of a failing non-member futures commission merchant by the CFTC is likely to occur at a later date than exchange intervention into the business of one of its clearing members, there is greater chance that the funds of the customers of a non-member futures commission merchant will not be in

segregation when the CFTC intervenes, resulting in a greater loss of customer funds. The trustee's alternatives to closing out customers' open contracts are either a transfer of the contracts, along with the margin deposited to secure such contracts, or undertaking actual operation of the bankrupt futures commission merchant's business.

This leads directly into the question of how the trustee in the bankruptcy of a futures commission merchant is to distribute those assets which can be traced to commodity customers. There are, essentially, three basic alternatives. First, the trustee can, to the greatest extent possible, return all specifically identifiable assets to the customers of the futures commission merchant to whom the assets are identified, making a pro rata distribution to all customers of whatever remains after the initial distribution. Second, the distribution can be pro rata from the start. This would entail the closing out of all customers' futures contracts. Third, the trustee can make a pro rata distribution of customers' funds and assets while preserving individual customers' interests in open futures contracts to safeguard the hedging mechanism and other specifically identifiable assets to the extent possible.

The first alternative, strict tracing to individual customers, does preserve the hedging mechanism. Specifically identified contracts and specifically identified funds margining such contracts can be readily transferred to another futures commission merchant, provided such contracts are adequately margined; however, this approach, as previously pointed out, has one major drawback. Customers who deposit securities in lieu of cash as margin are in a much better position to assert that specific securities are theirs than customers who deposit cash are in a position to assert that x number of dollars in y account is theirs. The absolute fungibility of cash oftentimes defies tracing. The problem with the specifically identifiable asset approach to futures commission merchant bankruptcies is that it is primarily the large traders who deposit securities as margin and who are therefore in a position to trace their ownership interest to specifically identifiable assets in the event of a futures commission merchant bankruptcy. Small traders seldom maintain positions large enough to warrant the deposit of securities as margin; even when the opportunity presents itself, small traders seldom have the sophistication to take advantage of it. Consequently, should a futures commission merchant go into bankruptcy inadequately segregated or otherwise not in a position which lends itself to tracing all the cash deposited by commodity customers, small cash customers may recover only a small percentage of their investments upon the residual pro rata distribution, whereas large investors may recover their entire investments in the return of specifically identifiable securities.

The second alternative, strict pro rata distribution, requires the liquidation of all assets, including the closing out of all futures contracts. In so doing, it effectively destroys the hedging mechanisms for many customers, because, as explained above, it prevents them from re-establishing their hedging positions in the futures market until distribution.

The third alternative, a combination of the first two alternatives, both preserves the hedging mechanism and results in an equitable distribution of assets in the event of inadequate segregation. Pursuant to this approach, each customer's net equity would be determined as with a pro rata distribution. However, rather than liquidating customers' open futures contracts and making a distribution at this point, the open contracts would be specifically identified to individual customers. If a customer's share under the pro rata distribution is sufficient to margin his open contracts, such contracts, together with the necessary margin, would be transferred immediately to another futures commission merchant. Where a customer's share of the distribution is inadequate to margin his open contracts, he would be given a choice. In order to secure the transfer of all or a portion of his open contracts to another futures commission merchant, the customer could either deposit sufficient additional funds to adequately margin his contracts or request that certain of his open contracts be closed out to provide adequate margin for the others; or he could request that all his open contracts be liquidated. If the trustee in bankruptcy received no preference from a customer within a designated short period of time, he would close out all the open contracts in the customer's account. Specifically identifiable securities and property would be dealt with in a similar manner; returned to the customer who deposited them to the extent such distribution does not exceed the sum of the cus-

tomer's pro rata share plus any additional deposits made by the customer with the trustee to regain possession of that portion of the securities and property specifically identifiable to him in excess of his pro rata share.

Open contracts which are not adequately margined would be liquidated by the trustee if there were not adequate time to secure additional deposits from customers to facilitate the transfer of such contracts prior to the last day of trading in such contracts or the first day on which notice of intent to deliver on cash contracts con be tendered, whichever comes first. Contracts which have been kept open past the last day of trading (either for the purpose of taking or making deliveries of the underlying physical commodities or because of an inability to liquidate such open positions) and contracts on which notice of intent to deliver has been tendered (and not retendered in the case of a buyer) could not, of course, be liquidated. The trustee would have to deliver to operate the bankruupt futures commission merchant's business for the purpose of handling notices of intent to deliver and to facilitate delivery itself. This would have the advantage of preserving the contractual expectancies of customers who maintain open positions in a futures contract for the purpose of taking or making delivery of the actual physical commodities underlying such contract. (Open contracts trading in their delivery month or in which trading has stopped would have to be handled in a similar fashion under the first alternative, the specifically identifiable asset approach).

As equitable and advantageous as this third alternative appears, it is doubtful that it could be utilized under current law, which dictates either strict tracing and immediate return of specifically identifiable securities and property (with a residual pro rata distribution), or a single pro rata distribution, but not the combination outlined above. The CFTC therefore recommends that:

1. All commodity customers of a bankrupt futures commission merchant be entitled to share ratably in all money, securities, property, and open trades which can be traced to such customers in general;

2. Transfers of open trades or contracts, and the funds margining or securing such trades or contracts, made prior to or within five days of the date of bankruptcy and approved by the CFTC be protected from reversal by the trustee in bankruptcy;

3. Specifically identifiable assets, including open trades or contracts, be traced to individual customers of the bankrupt and returned to them to the extent of each customer's pro rata share or, in the case of open trades or contracts and corresponding margin, either transferred to another futures commission merchant to the extent of each customer's pro rata share or liquidated upon the instruction or inaction of such customer;

4. To the extent the value of specifically identifiable assets, including open trades or contract, exceeds the value of a customer's pro rata share, he be given the opportunity to deposit sufficient cash to account for the difference and thereby to gain the return or transfer of all such specific assets;

5. The trustee be authorized to answer all margin calls or customers' open trades to the extent of the pro rata share of each customer until transfer or liquidation of such trades occurs;

6. Commodity customers be given a short period of time to file claims and to instruct the trustee as to how to handle their open trades or contracts;

7. Open contracts which are not adequately margined be liquidated by the trustee where there is not adequate time to secuure additional deposits from customers to facilitate the transfers of such contracts prior to the last day of trading in such contracts or to the first day on which notice of intent to deliver can be tendered, whichever occurs first;

8. The trustee be authorized to maintain the business operations of the bankrupt for the purpose of handling notices of intent to deliver on contracts which have remained open past the last day of trading in such contracts or with respect to which notice of intent to deliver has been tendered (and, in the case of a buy contract, not retendered) and to facilities delivery thereon;

9. The CFTC be given the power to provide by rule or regulation that certain assets, including open trades or contracts, are traceable to a particular customer; and

10. The trustee be instructed to effect, to the extent possible, a prompt distribution of all customer assets not transferred to another futures commission merchant.

These provisions would eliminate the inequities of specific tracing which unfairly favor the customer who deposits securities in lieu of cash as margin and yet, to the greatest extent possible, provides for the return of specifically identifiable assets. The CFTC's recommendations would also preserve the hedging mechanism for the customers of a bankrupt futures commission merchant by granting statutory recognition to the baility of the various contract markets to take prompt action to protect the commodity customers of their member firms by transferring customers' open trades and margin funds to other futures commission merchants. The proposed amendments would give the CFTC the ability to insure that such transfers are effected in an equitable manner through the power to approve such actions and thereby to protect them from later reversal by the trustee in bankruptcy. These provisions would also enable the CFTC to effect such transfers itself in the case of a nonmember futures commission merchant. In addition, where open customer trades or contracts have not been transferred or liquidated prior to the assumption of duties by the trustee in bankruptcy, the CFTC's proposals would further protect the hedging mechanism by authorizing the trustee in bankruptcy to maintain customers' open contracts until such customers can come up with sufficient additional margin to permit transfer of such contracts or until they direct liquidation. Finally, the hedging mechanism is further protected through the provision for a prompt distribution of any remaining margin funds, thereby permitting closed out hedging positions to be reopened as quickly as possible.

The question may arise as to how open contracts, customer securities (and property) deposited in lieu of cash, and customers' net equities can be identified to individual customers. CFTC regulations require that detailed records be kept by a variety of persons at several points in the course of a futures transaction. Regulation 1.37 requires each futures commission merchant to keep a ledger showing for each customer all charges, credits, deposits, losses, gains and the details of all transactions relating to the futures commission merchant's commodity business, and regulation 1.35(a-1), requires that each customer order be identified to an account, given an order number, and time-stamped. (Each contract market member, or floor broker, receiving such a customer order on the floor of the exchange in oral form much identify the order by account and order number, and time-stamp it.) Regulation 1.33 requires each futures commission merchant to furnish each customer a monthly statement showing, among other things, the open contracts in that customer's account with the prices at which acquired, the ledger balance carried for the customer's account, and any unrealized profit or loss on the customer's open contracts. Copies of such statements must be retained by the futures commission merchant for five years. Because of these requirements of regulations 1.35 and 1.33, a customer's net equity and his open contracts should be readily identifiable. Finally, regulation 1.36(a) requires each futures commission merchant to maintain a detailed record of all securities and property received from customers to margin their accounts, showing separately for each customer:

1. A description of the securities or property,
2. The identity of the customer depositing the securities or property,
3. The date of receipt,
4. The depositories where such securities and property are segregated,
5. The dates of deposit into and withdrawal from such depositories,
6. The dates the securities and property are returned to the customer, and
7. The details of any other disposition of the securities and property.

Regulation 1.36(a) requires further that the futures commission merchant obtain an acknowledgement from any depository into which such customer securities have been deposited that the depository was informed such securities and property belong to a particular customer. Regulation 1.33 requires that the monthly statement the futures commission merchant furnishes to each customer clearly show any securities or other property deposited by the customer as margin. These requirements of regulations 1.36(a) and 1.33 should enable a trustee in the bankruptcy of the futures commission merchant to identify specifie securities and property to individual customers.

Margin Deposits Prior to Bankruptcy

The CFTC's fifth concern in the event of the bankruptcy of a futures commission merchant is the treatment by the trustee of margin deposits and

payments made to a clearing house or another futures commission merchant by the bankrupt futures commission merchant prior to the filing of a petition in bankruptcy. As I have previously explained, the primary function of the clearing house system is to insure the integrity of futures contracts accepted for clearance. This is accomplished primarily through the variotion margin system, through which the clearing house guarantees each party on the profitable side of a transaction that he will receive that profit. This system also reduces the incentive for default on delivery and makes it easier to cover any default on delivery by marking each contract to the market price each day. As described above, original margin deposits are actually security deposits. Variation margin "deposits", on the other hand, are actual payments of losses, not deposits in any sense of the term. The clearing house's guarantee is that it will pay the net credit claims of its clearing members regardless of whether its losing clearing members answer the margin calls or not. The extent of the risk which is assumed by the clearing house is that it will have to answer variation margin calls to a defaulting clearing member with its own funds until it can close out that clearing member's open contracts. Only the defaulting clearing member's original margin deposits are immediately available to offset any losses the clearing house might incur as a result of making such payments. However, a recent New York federal district court case strongly suggests that the liability or risk of a clearing house might be much greater.

In *Seligson* v. *New York Produce Exchange, et al.*, CCH Commodity Futures Law Rep. ¶ 20,029 (S.D.N.Y. 1975), the trustee in the bankruptcy of Ira Haupt & Co., a futures commission merchant, acting pursuant to section 70(e) of the Bankruptcy Act, 11 U.S.C. 110(e), sought to set aside payments by Ira Haupt & Co. of over $12 million in variation margin on the bankrupt's customers' account to the New York Produce Exchange Clearing Association. The trustee alleged that the variation margin payments were fraudulent transfers under section 273-275 of the New York Debtor and Creditor Law in that they were made without fair consideration at a time when Ira Haupt & Co. was insolvent, and that therefore the New York Produce Exchange Clearing Association was a fraudulent transferee.[31] Before the court was a motion by the New York Produce Exchange Clearing Association for a summary judgment denying the trustee in bankruptcy the relief he sought. The United States District Court for the Southern District of New York denied the motion. In so doing, the court made certain statements which, if given a chance to evolve into established precedent, threaten to destroy or drastically change the clearing house system, the heart of the futures industry.

Ira Haupt & Co. made the $12 million in variation margin payments on behalf of a single customer over a five-day period. In order to meet, among other things, the maintenance margin calls made to it by Ira Haupt & Co., this customer had borrowed $31.8 million from Ira Haupt & Co., which loan was secured by warehouse receipts given to Ira Haupt & Co. as collateral. Ira Haupt & Co. in turn was forced to borrow funds to meet variation margin calls made on this customer's contracts. It was then discovered that the warehouse receipts used as collateral by the customer were spurious. This forced Ira Haupt & Co. into bankruptcy with a deficit of over $25 million. It appeared clear to the court that Ira Haupt & Co., was insolvent when it made the $12 million in variation margin payments to the New York Produce Exchange Clearing Association, which the trustee sought to recover.

In denying the motion for summary judgment, the court cited a Second Circuit Court of Appeals decision which held that consideration must be given in good faith to constitute "fair consideration" and which indicated that: "if the transferee had knowledge of the unfavorable financial condition of the transferor at the time of the transfer, it could not meet the good faith requirement." (CCH Comm. Fut. L. Rep. ¶ 20,029, at 20,593.)

The court then reasoned that since the New York Produce Exchange Clearing Association was at least aware of the precarious market position of Ira Haupt & Co. and its customer, there was a "genuine issue of material fact as to the Association's good faith." The court also held that there was a

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[31] Section 273 of the New York Debtor and Creditor Law provides in pertinent part: "Every conveyance made * * * by a person who is or will be thereby rendered insolvent is fraudulent as to creditors without regard to his actual intent if the conveyance is made * * * without fair consideration."

factual issue as to whether the value of the consideration given Ira Haupt & Co. by the New York Produce Exchange Clearing Association was adequate. This holding was based on section 272 of the New York Debtor and Creditor Law which requires that the consideration be such that the bankrupt's estate is not depleted as a result of the transfer. The court even went so far as to question whether the consideration given by the New York Produce Exchange Clearing Association "in any way offset the depletion of the Ira Haupt & Co. estate by the transfer of $12 million in margin." Nor would the court accept the argument of the New York Produce Exchange Clearing Association that its acceptance for clearance of the contracts entered into by Ira Haupt & Co. on behalf of its customer contstituted an antecedent indebtedness constituting "fair consideration." The court therefore denied the motion for summary judgment on the grounds that there were "genuine issues of material fact as to whether Haupt received 'fair consideration.' "

The New York Produce Exchange Clearing Association also argued that it was merely the agent of profiting clearing members for the receipt of variation margin payments from losing clearing members and was therefore protected from liability for good faith payments of the money received from Ira Haupt & Co. to its clearing members. The court rejected this argument stating that it was "most doubtful that the Association had presented facts sufficient to support a finding of an agency relationship," that there was no "evidence that Haupt made the margin payments by mistake"—a necessary element to the agency defense, and that there was "a serious issue as to the Association's good faith in accepting the variation margin payments."

As a result of this decision, the risk the clearing house assumes may be greatly increased. Since a clearing house, by its very nature, must always have knowledge of the market positions of its clearing members, a clearing house's "good faith" in accepting margin payments from its clearing members is always open to question. As a result, the clearing house may be forced into a position where it is the guarantor not only of any variation margin payments its clearing members might fail to make between their first such failure and the closing out of their positions, at most a few days, but also of any payments they make over a much longer period of time, perhaps over several months. The difference is that between the guarantor of obligations conceivably running into several hundred thousand dollars and being the guarantor of obligations easily running into tens of millions of dollars. Even the financial stability of the clearing houses, with often millions of dollars at their disposal, would be severely threatened by such exposure.

The CFTC therefore recommends that all variation margin payments made to, and all original margin deposits made with, any clearing house or other futures commission merchant by the bankrupt futures commission merchant prior to the date of bankruptcy, unless made in collusion with such clearing house or such futures commission merchant with the intent of defrauding other creditors of the bankrupt futures commission merchant, be protected from reversal by the trustee in bankruptcy. Any such provision should also clearly preempt state law in this area.

FUTURES COMMISSION MERCHANTS—SPECIFIC RECOMMENDATIONS

The CFTC recommends that Congress amend the Bankruptcy Act to provide as follows:

Where the bankrupt is a futures commission merchant:

1. *All money, securities, and property received by the bankrupt to margin, guarantee, or secure the trades or contracts of customers for the purchase or sale of a commodity for future delivery traded or executed on a contract market designated as such by the CFTC pursuant to section 5 of the CE Act, all money accruing to such customers as the result of such trades or contracts, all such open trades or contracts, and all other assets segregated pursuant to section 4d of the CE Act in whatever form such assets may exist, constitute a single and separate fund. All commodity customers of the bankrupt constitute a single and separate class of creditors and are entitled to shart ratably in such fund on the basis of their net equities as of the date of bankruptcy.*

Explanation: This provision grants commodity customers a statutory preference to all funds segregated pursuant to section 4d(2) of the CE Act and

the regulations thereunder or otherwise traceable to such customers. It also provides for a pro rata distribution of such funds, thereby eliminating the inequities of specific tracing which unfairly favor the large sophisticated industrial hedger over the small and generally unsophisticated hedger or speculator, who is typically a member of the general public.

2. *No transfer of the open commodity futures trades or contracts entered into by the bankrupt on behalf of his customers and the money, securities, and property margining or securing such open trades or contracts and no liquidation of any open trades or contracts entered into by the bankrupt shall be set aside as a voidable preference, a fraudulent conveyance, or otherwise: Provided, such transfer or liquidation has been approved by the CFTC or an authorized representative thereof and is made prior to or within five days of the date of bankruptcy.*

Explanation: This provision permits the CFAC to approve the current self-regulatory actions of the various commodity exchanges and their clearing houses and, by such approval, to protect such actions from later reversal by a trustee in bankruptcy. Due to the nature of the futures markets, it is impossible for a trustee in the bankruptcy of a futures commission merchant to be appointed, to be educated with respect to the workings of the futures industry, and to subsequently act in a sufficiently short period of time to adequately preserve the hedging mechanism for the customers of the bankrupt futures commission merchant. The exchanges, however, with their systems of continual surveillance, have demonstrated their ability to act responsibly and promptly to protect the interests of the customers of a failing futures commission merchant by transferring customers' trades or contracts and margin deposite to another futures commission merchant. The requirement that such actions be approved by the CFTC in order to gain protection from reversal by the trustee in bankruptcy assures that any such exchange action will be done equitably, in a manner consistent with a pro rata distribution, and in the best interests of the general public. This provision enables the CFTC to prevent customers' trades and contracts from being closed out whenever there are not enough segregated funds to margin those trades or contracts at the futures commission merchant level, by withholding approval of such liquidations from contract markets which do not afford such customers an opportunity to deposit sufficient additional funds to permit the transfer of their trades or contracts to another futures commission merchant. It also enables the CFTC itself to effect transfers of the trades or contracts and funds of the customers of non-member futures commission merchants with respect to whom the exchanges are powerless to act. In this regard it must be noted that the CFTC is currently developing an early warning system to provide it with ample time to monitor the business of any futures commission merchant experiencing financial difficulty and to enable it to take effective action for the protection of customers *prior to* the insolvency of member and non-member futures commission merchants. Finally, this provision permits customers' trades or contracts which cannot be satisfactorily transferred to be closed out or liquidated withoutu fear of reversal.

3. *The net equity of each customer is to be determined by adding all money, securities, property, and open commodity futures trades or contracts in the customer's account, in whatever form, and including any trades or contracts transferred, along with the money, securities, and property margining such trades or contracts, to another futures commission merchant pursuant to provision number 2 above, and by subtracting any indebtedness of the customer; provided, however, that open commodity futures trades or contracts shall be marked to the market each day until liquidation or transfer.*

Explanation: This provision enables the trustee to maintain customers' open futures positions, and thereby to preserve the hedging mechanism, until distribution or transfer, without upsetting the pro rata distribution of customer's funds. As can be observed, any transfer of customer's trades or contracts effected by the CFTC or an exchange is taken into consideration in determining the net equity of that customer.

4. *Specifically identifiable securities, property, and open futures trades or contracts are to be traced to the bankrupt's customers who are entitled thereto and promptly returned to them or transferred to another futures commission merchant on their behalf to the extent such distribution does not exceed the pro rata share to which such customers are entitled. In the event the value of specifically identifiable securities, property, and open futures trades or*

contracts exceeds a customer's pro rata share, that customer may deposit money with the trustee equal to the excess of the value of the specifically identifiable securities, property, and open commodity futures trades or contracts over such customer's pro rata share, in which case such excess specifically identifiable securities, property, and open commodity futures trades or contracts will also be promptly returned to such customer or transferred to another futures commission merchant on his behalf. The trustee shall answer all margin calls with respect to a specifically identifiable open futures trade or contract up until such time as the trustee shall either transfer or liquidate such trade or contract; provided, however, that no margin payments shall be made, the effect of which is to reduce any customer's pro rata share below zero.

Explanation: As explained above, strict tracing distribution will greatly and unfairly favor large industrial hedgers over the members of the general public who lack both the ability and the sophistication to deposit securities as margin. Pro rata distribution eliminates this inequity. This provision requires the return of specifically identifiable assets to the appropriate customers of the bankrupt without destroying the equity of a pro rata distribution, thereby protecting the unique ownership interests of commodity customers in specifically identifiable assets. It also enables the trustee to further protect the hedging mechanism by maintaining adequate margin on customers' open trades and contracts until instructions for transfer are received or such trades or contracts are liquidated.

5. *Customers have 30 days from the date of dispatch of the notice of liquidation to submit claims to the trustee, including claims to specifically identifiable assets, and to instruct the trustee as to whether open commodity futures trades or contracts identified to them are to be transferred to another futures commission merchant or liquidated; provided, however, that the trustee shall not permit any such open trades or contracts which are being actively traded as of the date of bankruptcy to remain open past the last day of trading in such contract or into the first day on which notice of intent to deliver on such contract can be tendered, whichever occurs first, but shall instead liquidate such contracts whenever their transfer to another futures commission merchant cannot be accomplished prior to the last day of trading. All open commodity futures trades or contracts which are identified to particular customers and with respect to which no instruction as to their disposition has been received by the end of such 30 day period, and all open commodity futures trades or contracts which cannot be identified to a particular customer, shall be liquidated; provided, however, that with respect to open trades or contracts which have remained open past the last day of trading in that contract or with respect to which delivery must be made or accepted pursuant to the rules of the contract market, the trustee is authorized to operate the business of the bankrupt for the purpose of accepting or making tender of notice of intent to deliver the physical commodity underlying such trades or contracts and facilitating such delivery.*

Explanation. This provision further instructs the trustee as to the handling of customers' open positions. The short 30-day period for submission of claims and instructions is due to the need for a promptly distribution of customers' funds to enable hedgers to re-enter the futures market in the event their open futures trades or contracts can not be transferred to another futures commission merchane. If the bankrupt is a member futures commission merchant, the bankrupt's customers' trades or contracts will probably have been transferred or closed out by the exchange before the trustee takes over. In the event such trades or contracts are not transferred or closed out prior to the date of bankruptcy, the trustee is instructed to liquidate all remaining trades or contracts, including those customer trades or contracts for which he receives no instructions. The trustee is not permitted, however, to permit any open trade or contract to lapse into a deliverable position. A customer of the bankrupt desiring to make or accept delivery on any contract which is trading as of the date of bankruptcy would have to have his trades or contracts transferred to another futures commission merchant while trading in such contracts is still open. On the other hand, the trustee is authorized to accept and to tender delivery notices and to facilitate delivery with respect to open contracts in which trading has already stopped or with respect to which notice of intent to deliver has already been tendered as of the date of bankruptcy.

6. *All remaining securities and property in the single and separate fund shall be converted into cash, and, to the extent possible, be promptly distributed to the bankrupt's customers in such a manner as to insure each customer his pro rata share.*

Explanation: This provision simply provides for the prompt pro rata distribution of customers' funds.

7. *The CFTC shall have the power to provide by rule or regulation that certain money, securities, property, and open commodity futures trades or contracts are to be included in the single and separate fund, and that certain money, securities, property, and open commodity futures trades or contracts are to be specifically identifiable to a particular customer.*

Explanation: This empowers the CFTC to specifically include certain assets within the single and separate fund and, as the Securities Investor Protection Act empowers the Securities and Exchange Commission to determine which assets are specifically identifiable to particular customers. This power can only be exercised by rule or regulation and not on a case-by-case basis. It enables the CFTC to provide for uniform tracing and distribution in futures commission merchant bankruptcies.

8. *No margin payment to or deposit with any clearing house of a commodities exchange or another futures commission merchant by the bankrupt prior to the date of bankruptcy, unless made in collusion with such clearing house or such futures commission merchant with the intent of defrauding other creditors, shall be set aside as a voidable preference, a fraudulent conveyance, or otherwise, under either state or federal law.*

Explanation: This eliminates the *Seligson* problem discussed above.

9. *The CFTC shall receive prompt notice of the filing of the petition in bankruptcy and shall receive copies of any filings in the bankruptcy proceeding. On its application, the CFTC shall be admitted as a party, to the extent it deems appropriate, in the bankruptcy proceeding.*

Explanation: This provision will enable the CFTC to assist the trustee in handling the bankruptcy of the futures commission merchant. It will also force interested parties, specifically, creditors of the bankrupt, to respond to any pleading filed by the CFTC.

CLEARING HOUSES—OVERALL CONCERNS

My discussion of the problems surrounding the bankruptcy of a futures commission merchant is, in many respects, equally applicable to the bankruptcy of a clearing house. In fact, technically, the clearing house situation presents far fewer complications because a clearing house deals strictly with its clearing members in a relationship well-defined by the exchange's or the clearing house's rule book. However, there is the additional problem of what protection should be afforded a clearing member's own house account in the event of the bankruptcy of the clearing house.

Section 4d(2) of the CE Act and CFTC regulation 1.29(b) require a clearing house to segregate and separately account for all funds received from a clearing member to margin, guarantee or secure the trades or contracts of the clearing member's customers or accruing to such customers as the result of trades or contracts carried by the clearing house. A clearing house is further prohibited from holding, using, or disposing of such funds except as belonging to the customers of its clearing members. As a result, a clearing house will generally maintain, or require its clearing members to maintain, two original margin accounts, one for customers' funds and one for house funds. Where the clearing house maintains its own original margin accounts with a bank or trust company (in other words, where original margin cashier's checks are made payable to the clearing house itself rather than to special accounts of its clearing members) the clearing house is required to deposit customers' funds under an account name which clearly shows that the funds therein are those of the customers of its members, segregated as required by the CE Act. The clearing house must also obtain an acknowledgement from the depository that it was informed that the funds deposited therein are the funds of the customers of the clearing house's members and are being held in accord with the CE Act. Customers' original margin deposits are therefore segregated from the funds of both clearing members and the clearing house. However, as I previously discussed, it is not possible to segregate the variation margin funds of customers from those of clearing members, and all variation margin payments are received into and paid out

from a single account. On the other hand, a clearing house can and is required to segregate customers' variation margin from its own funds. Since customers' and house variation margin funds are necessarrily commingled, a clearing house must segregate house variation margin apart from its own funds along with customers' variation margin. Although there is no requirement that a clearing house segregate its own funds from its clearing members' house original marginal deposits, such segregation generally occurs, primarily due to the fact that original margin is usually deposited in special bank accounts of the clearing members rather than with the clearing house.

As with segregation on the futures commission merchant level there is a very basic problem with segregation at the clearing house level, specifically: Will segregation do any good in the event of bankruptcy? Once again the argument can be made that the clearing house is a trustee of margin funds deposited with it by its clearing members. With respect to customers' funds, this argument would appear to be at least as strong as that urged with respect to futures commission merchants. In fact, as will be discussed below, it may even be stronger with respect to clearing houses because the segregation requirements of the CE Act and CFTC regulations are nowhere relaxed to permit the clearing house to commingle its own funds with those of the customers of its clearing members. However, the trust argument may be much weaker with respect to house funds deposited with the clearing house by its clearing members, because the segregation of such funds is not a requirement of either the CE Act or the regulations thereunder, but rather a byproduct of the clearing system. As with segregation at the futures commission merchant level, the effectiveness of segregation at the clearing house level in the event of bankruptcy has never been determined at the appellate court level. There is, therefore, no directly applicable authority for the proposition that clearing members are entitled to a preference to margin funds on deposit with their bankrupt clearing house.

Another problem mentioned in connection with segregation at the futures commission merchant level, specifically, violations of the segregation requirements of the CE Act and the regulations thereunder, does not appear to be as significant with respect to segregation at the clearing house level for two reasons. First, because original margin is deposited, in most instances, into bank accounts of the clearing house's clearing members and not with the clearing house, and because the variation margin paid into the clearing house is paid out again almost immediately, there may simply be no opportunity to violate segregation. Second, there is much less likelihood of a clearing house violation of these segregation requirements going undetected for any significant time period due to the fact that there can be only as many clearing houses as there are exchanges (14, as of this submission) and each clearing house is subject not only to SFTC surveillance but to the scrutiny of the market place as well. that provided by its own members.

Similarly, a third problem mentioned in connection with segregation at the futures commission merchant level, the inability to maintain or to require strict segregation at all times. is much less on a problem at the clearing house level. While customers' and clearing members' house funds must be commingled in the clearing house's variation margin account, the clearing house is strictly prohibited from commingling its own funds with customers' margin funds and, due to the clearing system, generally does not commnigle its own funds with its clearing members' house funds. There is only one minor relaxation of CFTC segregation requirements permitted. Regulation 1.25 permits a clearing house to invest the funds of its clearing members' customers deposited with it as margin in certain specified obligations. Regulation 1.29 permits a clearing house to retain the profits of such investments. However, due to the manner in which deposits of original margin are most frequently made, clearing house investment of both customers' and clearing members' house funds is much less extensive that the investment of customers' funds by futures commission merchants. The opportunity for such investment is further reduced by the fact that futures commission merchants often invest customers' funds in permissible securities before depositing such funds with a clearing house or its correspondent bank as original margin. Customers' funds tied up in investment by futures commission merchants cannot, obviously, be invested by the clearing house. Where the funds of clearing members' customers are invested by a clearing house, section 4d(2) of the CE Act and regulation 1.26(b) require that such investments be segregated

and separately accounted for in the same manner as the funds originally deposited on behalf of such customers, and regulation 1.27 requires the clearing house to keep detailed records of such investments similar to those which a futures commission merchant is required to keep with respect to his investments of customers' funds.

As can be seen from the above discussion, it should be a relatively simple task for a trustee to trace or identify the money, securities, and property of clearing members in the event of the bankruptcy of a clearing house. Moreover, due to the CE Act and CFTC regulations, it should also be fairly easy to trace particular assets to particular clearing members and to distinguish customers' assets from house assets. All open contracts must, of course, belong to the clearing members of the clearing house. CFTC regulation 1.35(e) requires each contract market or its clearing house to identify each contract to a buying and a selling clearing member and to specify the type of person for whom the trade was made, so each open contract can be identified to a particular clearing member and to either that clearing member's customers' or house account. A clearing house receiving securities or property as margin which belong to a particular customer is required by regulation 1.36(b) to maintain a record showing separately for each clearing member, the dates such securities or property were received, the identity of the depositories where such securities are segregated, and the dates such securities or property were returned to the clearing member or otherwise disposed of, together with the details of such other disposition including the authorization therefor. (This is in addition to the acknowledgement of the particular ownership of such securities or property required by regulation 1.36(a) previously discussed.) Therefore, all customers' securities and property should be readily iidentifiable, even without reference to the clearing members' own records. A clearing house which receives obligations from its clearing members which represent the investment of customers' funds must, pursuant to CFTC regulation 1.27(b), keep a record, showing separately for each member, the date of receipt, a description of the obligations, and the date of return to the clearing member or the details of disposition by other means. This, in combination with the records of the clearing members, should enable the trustee in the bankruptcy of the clearing house to trace obligations in which customers' funds have been invested by a clearing member back to the customers of that clearing member.

The only real tracing problems then, in the bankruptcy of a clearing house, would involve (1) securities and property deposited by a clearing member for his house account; (2) securities and property which represent the investment of a clearing member's house funds; and (3) cash deposits, particularly those in clearing members' house accounts. Each clearing member's own records should enable the trustee to trace and identify securities and property deposited by the clearing member. CFTC segregation and separate accounting requirements, if complied with (the CFTC monitors such compliance), will enable the trustee to trace customers' cash in segregation to the appropriate clearing members. Finally, the remaining money, securities, and property should be either identifiable to particular clearing members due to the separate bank account original margin deposit system or identifiable to clearing members' house accounts in general, in which case a pro rata distribution could be made.

As with the tracing problem discussed above, the question of what to do with open contracts upon the banqruptcy of the clearing house is also simplified. Since the bankruptcy of the clearing house destroys the exchange's futures market, all open positions would have to be closed out. This would undoubtedly have been done by the exchange itself prior to the appointment of either the trustee or a receiver in bankruptcy. Any contracts which have remained open past the final day of trading in the contract or with respect to which notice of intent to deliver has been tendered would, however, present a problem. Assuming all powers of the clearing house, the trustee could simply order the liquidation of all such contracts at a determined price. Assuming a properly functioning market (which is unlikely in the event of the bankruptcy of a clearing house), those persons who kept their contracts open past the last day of trading or who tendered or stopped notice of intent to deliver probably desired to make or to accept a delivery; a liquidation of their contracts would deprive them of the expected performance on their contracts. However, due to the fact that (1) it is highly unlikely that an exchange would maintain a properly functioning futures market in the event of the collapse of its clearing

house and (2) the use of the futures market to either make or take delivery of the cash commodity underlying the futures contract is not one of the primary functions of the futures market system (as previously mentioned, delivery on futures contracts seldom occurs and is rarely anticipated), liquidation of all open contracts, even those in deliverable position, would appear to be the preferable approach to all open contracts. (This is in sharp contrast to the recommended handling of open trades or contracts in the event of a futures commission merchant bankruptcy.)

The CFTS's final concern in the event of the bankruptcy of a clearing house concerns the treatment by the trustee of margin payments made to clearing members by the clearing house prior to the filing of a petition in bankruptcy. While the holding in the *Seligson* case discussed above does not extend to such payments, it is conceivable that a court might find such payments voidable preferences. If this should occur, the clearing members would be required to return the payments made to them by the clearing house, payments which in many cases would have already been transferred to the customers of the clearing members. Such a requirement might, in turn, cause the insolvency of several clearing members. Since clearing members of one exchange are often clearing members of several exchanges, other clearing houses to which these clearing members had made variation margin payments while insolvent might have to return those payments to the trustee in the bankruptcies of the insolvent clearing members under the reasoning in the *Seligson* case. These other clearing houses might, in turn, be rendered insolvent themselves by returning such variation margin payments, etc., etc., etc. As can be seen, a chain reaction might occur, threatening the entire industry.

CLEARING HOUSES—SPECIFIC RECOMMENDATIONS

In light of the concerns expressed in the preceding section of this submission, the CFTC recommends that Congress amend the Bankruptcy Act to provide as follows:

Where the bankrupt is a clearing house,

1. *All money, securities, and property received by the bankrupt to margin, guarantee, or secure the trades or contracts of the customers of its clearing members for the purchase or sale of a commodity for future delivery traded or executed on a contract market designated as such by the CFTC pursuant to section 5 of the CE Act, all money accruing to such customers as the result of such trades or contracts, and all such open trades or contracts, in whatever form such assets may exist, constitute a single and separate fund. All clearing members of the bankrupt constitute a single and separate class of creditors and are entitled to share ratably in such fund on behalf of their customers on the basis of the net equities in their customers' accounts as of the date of bankruptcy.*

Explanation: This provision grants clearing members, on behalf of their commodity customers, a statutory preference to all funds segregated pursuant to section 4d(2) of the CE Act and the regulations thereunder or otherwise traceable to such customers. It also provides for a pro rata distribution of such funds, thereby eliminating the inequities of specific tracing which unfairly favor the large industrial hedger at the expense of the small hedger or speculator.

2. *All money, securities, and property received by the bankrupt to margin, guarantee, or secure the trades or contracts in the proprietary accounts of its clearing members for the purchase or sale of a commodity for future delivery traded or executed on a contract market designated as such by the CFTC pursuant to section 5 of the CE Act, all money accruing to such clearing members as the result of such trades or contracts, and all such open trades or contracts, in whatever form such assets may exist, constitute a single and separate fund. All clearing members of the bankrupt constitute a single and separate class of creditors and are entitled to share ratably in such fund on the basis of the net equities in their proprietary accounts as of the date of bankruptcy.*

Explanation: This provision grants clearing members of the bankrupt a statutory preference to all funds traceable to such clearing members which is very similar to the one granted such clearing members on behalf of their customers. Again, pro rata distribution is provided for to insure equal treatment of both small cleaaring members (those frequently cleaaring only for their own accounts) and large clearing members.

3. *No liquidation or other termination of the open commodity futures trades or contracts carried by the bankrupt and no return or other payment of the money, securities, and property margining or securing such trades or contracts by the bankrupt shall be set aside as a voidable preference, a fraudulent conveyance, or otherwise: Provided, such liquidation or other termination and such return or other payment has been approved by the CFTC or an authorized representative thereof and is made prior to or within five days of the date of bankruptcy.*

Explanation: This provision is similar to that for futures commission merchants. Although the exchange itself will undoubtedly cease trading activities upon the failure of its clearing house, there are several commodities in which more than one exchange is designated as a contract market. As a result, a hedger forced out of his futures position by the bankruptcy of one exchange's clearing house, and consequently exposed to the risk of adverse price movements in the cash market, can often re-establish his hedge on another exchange. As previously discussed, however, a hedger may only be able to do this if the margin he deposited to open his first hedge position in the futures market is returned to him. This provision permits the CFTC to work with an exchange and its clearing house to liquidate all open contracts and to return to margin deposits to clearing members promptly, thereby reducing the minimum duration of price change exposure in the cash market to a few days. As previously noted, it would be impossible for a trustee in bankruptcy to make such a prompt return of margin deposits. CFTC approval of liquidations and returns margins would, of course, be granted only where such actions are accomplished in a manner consistent with a pro rata distribution and in the best interests of the general public. If the return of margin is not possible, the CFTC would still be able to act so as to effect the orderly liquidation of all open contracts on an exchange whose clearing house has failed, including those contracts in a deliverable position, leaving the actual distribution of margin to the trustee in bankruptcy.

4. *The net equity in both the customers' account and the proprietary account of a clearing member is to be determined by adding all money, securities, and property in such account, after marking each open position in a commodity in such account to the market on the last day of trading in any contract in that commodity and making the appropriate variation margin adjustments, and by subtracting any indebtedness of the clearing member with respect to such account.*

Explanation: Not equity is defined in a standard manner. Since the exchange itself will undoubtedly cease trading activities in the event of the failure of its clearing house, there is no provision for continuing the variation margin past the last day of trading in a commodity. The last day of trading in the commodity, rather than in each individual contract, was chosen because contracts closed in a normal manner, rather than by the failure of the clearing house, are marked to the market after trading in the contract ends and such contracts should continue to be so marked to the market until all trading in the commodity itself has ended or delivery on the contract is or must be made pursuant to exchange rules.

5. *All open commodity futures trades or contracts are to be liquidated.*

Explanation: As previously discussed, this should already have been accomplished by the contract market itself. In the unlikely event trades or contracts remain open past the date of bankruptcy, they should be liquidated.

6. *Specifically identifiable securities and properties are to be traced to the bankrupt's clearing members who are entitled thereto, either for their own proprietary accounts or on behalf of customers, and promptly returned to them to the extent such distribution does not exceed the pro rata share to which such clearing members, either for their own proprietary accounts or on behalf of customers, are entitled. In the event the value of specifically identifiable securities and property exceeds a clearing member's pro rata share, that clearing member may deposit money with the trustee equal to the excess of the value of the specifically identifiable securities and property over such customer's pro rata share, in which case such excess specifically identifiable securities and property will also be returned to such clearing member.*

Explanation: This provision requires the return of specifically identifiable assets to the appropriate clearing members of the bankrupt without destroying the equity of a pro rata distribution. As noted above, a strict tracing distribution will greatly and unfairly favor large industrial hedgers and clear-

ing members over the members of the general public and small clearing members who lack either the ability or the sophistication to deposit securities as margin, or both. There is no provision for the return or directed liquidation of open futures contracts which may be identified to a particular clearing member because trading on the exchange will undoubtedly have ended by the time the trustee in the bankruptcy of the clearing house is appointed. Such contracts will, of course, have to be identified to particular clearing members for the purpose of determining each clearing member's net equities. However, there is no reason and no way to actually return such contracts themselves to the clearing members. The only assets for distribution to the clearing members are the money, securities, and property deposited by them as margin.

7. *Clearing members have 30 days from the date of dispatch of the notice of liquidation to submit claims to the trustee, including claims to specifically identifiable securities and property.*

Explanation: Again, the shortened period for submission of claims is to enable hedgers to re-enter the futures market as soon as possible to prevent unnecessary exposure to price fluctuations in the cash market. As discussed above, while the bankruptcy of the clearing house of an exchange will undoubtedly be accompanied by the collapse of the exchange itself, there are several instances in which more than one exchange is designated as a contract market for trading in the same commodity. Since a hedging position can be re-established in another market in many situations, prompt release of margin funds is a necessity.

8. *All remaining securities and property in the single and separate fund shall be converted into cash and the fund shall be promptly distributed to the bankrupt's clearing members in such a manner as to insure each clearing member his pro rata share, both with respect to his customers' account and his proprietary account.*

Explanation: This provision simply provides for the prompt pro rata distribution of margin funds deposited by the bankrupt's clearing members.

9. *The CFTC shall have the power to provide by rule or regulation that certain money, securities, and property are to be included in the two single and separate funds established for the customers' accounts of the bankrupt's clearing members and for their proprietary accounts, respectively, and that certain such securities and property (as well as any open commodity futures trades or contracts, for the purpose of computing the net equities of the clearing member) are to be specifically identifiable to a particular member, either for his customers' account or for his own proprietary account.*

Explanation: This empowers the CFTC to specifically include certain assets within either of the two single and separate funds in which the bankrupt's clearing members are entitled to share. Again, this can only be done by rule or regulation and not on a case-by-case basis. Unlike the similar provision applicable to futures commission merchants, there is no need for this authority with respect to open trades and contracts, since all trades and contracts must necessarily belong to the bankrupt's clearing members. This provision also empowers the CFTC to designate which assets, including open trades and contracts for the purpose of computing the net equities of clearing members, are specifically identifiable to particular clearing members. This provision permits the CFTC to provide for uniform tracing and distribution in clearing house bankruptcies.

10. *No payment or release of margin to any clearing member by the bankrupt prior to the date of bankruptcy, unless made in collusion with such clearing member with the intent of defrauding other creditors, shall be set aside as a voidable preference, a fraudulent conveyance, or otherwise, under either state or federal law.*

Explanation: This eliminates the *Seligson* problem discussed above.

11. *The CFTC shall receive prompt notice of the filing of the petition in bankruptcy and shall receive copies of any filings in the bankruptcy proceeding. On its application, the CFTC shall be admitted as a party, to the extent it deems appropriate, in the bankruptcy proceeding.*

Explanation: This provision will enable the CFTC to assist the trustee in handling the bankruptcy of the clearing house. It will also force interested parties, specifically, creditors of the bankrupt, to respond to any pleading filed by the CFTC.

COMMODITY OPTION TRANSACTIONS AND LEVERAGE TRANSACTIONS

As I stated at the beginning of my presentation, there are newly developing areas within the commodity industry over which CFTC has been given broad regulatory authority. Two of these areas—commodity option transactions and leverage transactions in gold and silver—present all or some of the same fundamental problems in the context of present bankruptcy law as arise in the case of futures contracts: in the event the commodity option dealer or the leverage transaction merchant suffers bankruptcy, (1) whether and how a trustee in bankruptcy will permit tracing of, or grant preferences to, the funds invested by customers in these transactions and the assets accruing to their benefit, (2) if a preference is granted, how will assets be distributed, (3) how will open contractual commitments of the bankrupt be treated and (4) to what extent will the concept of voidable preferences interferes with the customary methods pursuant to which these transactions may be handled.

At the outset, I must stress that, as presently traded, commodity option transactions and leverage transactions are relatively new to the commodity industry and take diverse forms. Moreover, trading in commodity options on contract markets designated by the CFTC is only now being considered and has not yet been approved by the CFTC. Accordingly, the various relationships among the participants in these transactions are not nearly as susceptible of generalization as those in a futures contract transaction. Indeed, only since April 1975, when the CFTC Act became effective, has a regulatory agency had jurisdiction over these transactions. I should point out also that, unlike the case with respect to futures transactions, nowhere in the CE Act or in the CFTC Act has Congress stated the terms and conditions under which these transactions may take place or provided for the segregation of customer funds. Rather, Congress has directed the CFTC to make these determinations through adoption of appropriate regulations.

Naturally, the adoption of a definitive regulatory program in these two areas cannot occur without the CFTC engaging in a self-educational process through an exhaustive inquiry into how these transactions work, an inquiry which, as I will explain in more detail shortly, is only new reaching its completion. In this connection, I believe it significant that Congress gave the CFTC a full year to study, and to adopt regulations governing, commodity option transactions, and if more time was needed, authorized the CFTC to inform Congress of that fact. The CFTC has so informed the Congress.

Accordingly, Mr. Chairman, the CFTC's recommendations concerning the amendments to the Bankruptcy Act as they relate to commodity option transactions and leverage transactions will, of necessity, be more general in nature than those regarding futures contracts and the bankruptcy of futures commission merchants and clearing houses. Nevertheless, the basic thrust of these recommendations is the same: the CFTC regards its segregation requirements as the cornerstone of the protections afforded commodity customers in transactions subject to its jurisdiction and believes that the Bankruptcy Act must be amended to give full recognition to these requirements if the CFTC determines that they should apply to commodity option transactions and/or leverage transactions. At this time, I will endeavor to outline the issues confronting the CFTC in commodity option transactions and in leverage transactions which I believe warrant the implementation of its recommendations.

COMMODITY OPTION TRANSACTIONS

Section 4c(a)(B) of the CE Act, 7 U.S.C. 6c(a)(B), expressly forbids option transactions relating to those commodities which were regulated under the CE Act prior to the enactment of the CFTC Act,[32] thereby continuing to the CE Act's prohibition with respect to those commodities, traditionally domestic agricultural commodities.

The authority of the CFTC to regulate options involving commodities that are newly regulated by virtue of the CE Act's expanded definition of the term

[32] Prior to the effective date of the CFTC Act the CE Act provided for the regulation of "* * * wheat, cotton, rice, corn, oats, barley, rye flaxseed, grain, sorghums, mill feeds, butter, eggs, onions, Solanum tuberosum (Irish potatoes), wool, wool tops, fats and oils (including lard, tallow, cottonseed oil, peanut oil, soybean oil and all other fats and oils), cottonseed meal, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products, and frozen concentrated orange juice."

"commodity",[33] is contained in section 4c(b) of the CE Act, 7 U.S.C. 6c(b), which provides that

"No person shall offer to enter into, enter into, or confirm the execution of, any transaction [involving a newly regulated commodity] * * * which is of the character of, or is commonly known to the trade as, an 'option', 'privilege', 'indemnity', 'bid', 'offer', 'put', 'call', 'advance guaranty', or 'decline guaranty', contrary to any rule, regulation, or order of the Commission prohibiting any such transaction or allowing any such transaction under such terms and conditions as the Commission shall prescribe within one year after the effective date of the Commodity Futures Trading Commission Act of 1974 unless the Commission determines and notifies the Senate Committee on Agriculture and Forestry and the House Committee on Agriculture that it is unable to prescribe such terms and conditions within such period of time: Provided, That any such order, rule, or regulation may be made only after notice and opportunity for hearing: And provided further, That the Commission may set different terms and conditions for different markets." [34]

In general, commodity options are presently offered to the public by persons whom I shall call commodity option dealers. These options involve many of the newly-regulated commodities, such as coffee, cocoa, sugar, gold, silver and copper. The following description of a commodity option transaction is based on the nature of options transactions in general, is not description of the practices or policies of any particular firm or the components of any particular option contract, and is limited to a description of a "call" option on an actual commodity.

A call commodity option on an actual commodity grants the customer the right to buy an actual commodity from the commodity option dealer at a particular price and during a specified period. Although the particulars vary, certain features of these options transactions are common to all such transactions. The expiration date of the option is the date after which the option may not be exercised. The "striking price" of the option is a set price at which the option customer may buy the underlying commodity upon exercising the option. If the striking price is below the then-prevailing market price for the underlying commodity, the option is profitable. This is known in the trade as an option which is "in the money". However, the market price may be below the striking price during the option exercise period. In that event, the option is unprofitable or "out of the money" in the trade vocabulary.

At stake in the market price fluctuations of the underlying commodity which determine the profitability of the option is the option purchaser's investment in the option—the premium. The premium is the purchase price paid by the customer to the option dealer in order to obtain the option. The premium is not a standardized figure but is rather established by the dealer. Usually, dealers demand payment of the total option premium upon purchase of the option, although some dealers only require partial payment, in which case the customer may be subject to margin calls should the option go "out of the money." Also at stake is the customer's profit if the option is "in the money" during the time the option may be exercised.

To draw an analogy between an option transaction and a futures transaction, the payment by the customer of the premium is similar to the deposit by the customer of initial margin with a futures commission merchant. However, the amount of the premium is fixed, so that, if the entire premium is paid, there are no calls for maintenance margin. Should the customer pay only a part of the premium at the outset, however, there may be margin calls up to the full amount of the premium; these margin calls can be analogized to calls for maintenance margin on a futures contract. However, unlike the situation prevailing in futures contract transactions, there are presently no segregation requirements imposed on commodity option dealers as there are on futures commission merchants to insure that customers owning in the money options will realize on their transactions or even recoup their premiums if the option dealer defaults. Moreover, since options are not presently traded on contract markets, there does not exist the clearing house mechanism to insure performance on commodity options.

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[33] The expanded definition of commodity includes, in addition to the specific commodities set forth in section 2(a)(1) of the CE Act, "all other goods and articles [except onions] * * * and all services, rights and interests in which contracts for future delivery are presently or in the future dealt in * * *."

[34] By letters dated April 19, 1976, the CFTC notified the Chairman of these Committees that the CFTC would require more time to adopt definitive regulations.

Recent experience in the United States concerning the sale of commodity options dictates that the CFTC's regulations in this area incorporate adequate customer safeguards, the foundation of which would be segregation requirements similar to those imposed on futures commission merchants and clearing houses by section 4d(2) of the CE Act and the regulations thereunder. For example, the insolvency of one commodity option dealer resulted in a loss of 71 million dollars of customers' money. Due to the lack of regulation of this and similar companies, such as by the imposition of financial standards, segregation and other requirements, the only customer safeguard in such cases was the good faith and credit of the company involved. In many instances, customers who desired the proceeds of their transactions were paid with other customer's funds. Ultimately this pyramid collapsed.[35]

The task confronting the CFTC is compounded by the diverse nature of commodity options transactions. Recently, for example, there have been increased sales in the United States of so-called "London" options. Generally these involve an option on (i.e., the right to acquire) a futures contract traded on a foreign commodities exchange. Such options are often purchased by a U.S. commodity option dealer and carried in an omnibus account with a London broker. Generally the London broker considers only the U.S. dealer to be his customer and does not realize the interests of the dealer's customers. The U.S. dealer then will purport to sell the option to his U.S. customer, although the dealer may in fact be the only person who recognizes any obligations to the customer. At the present time, neither U.S. nor London vendors of these options are required to segregate from their general assets the funds paid by or accruing to the benefit of U.S. customers. Nor do foreign clearing houses recognizes and protect U.S. customers as do U.S. contract markets and their clearing houses. As a result, should the U.S. commodity option dealer of a London option suffer bankruptcy, his U.S. customer may not be able to have his claims recognized by the trustee in bankruptcy, except perhaps through the application of traditional trust principles similar to those applied in the case of bankrupt futures commission merchants.[36]

Thus far I have spoken only of options on actual commodities or on foreign futures contracts. However, there is a totally new option concept which has been presented to the CFTC for approval. This is the trading of options on futures contracts traded on contract markets designated by the CFTC. Two contract markets have proposals before the CFTC respecting such options. Both call for the margining of the premium to be paid by customers and the clearance of trades much along the lines of the margining and clearance of trades of futures contracts themselves which I have already discussed. Should these or other proposals to trade options on futures contracts be approved, it is likely that such approval will be conditioned on compliance with segregation requirements to be developed by the CFTC, similar to those provided in section 4d(2) and the regulations thereunder. Thus, virtually all of the concerns which I have already enumerated concerning the bankruptcy of futures commission merchants and of clearing houses will apply to this form of option trading, should the CFTC permit its implementation.

As previously stated, Congress has granted extensive power to the CFTC in section 4c(b) of the CE Act. The CFTC can prohibit all forms of option trading or prohibit some forms and permit others, under such terms and conditions as it prescribes. In order to gain sufficient data upon which to base its determinations, on October 30, 1975, the CFTC assigned to its Advisory Committee on Definition and Regulation of Market Instruments the responsibility to study the offer and sale of commodity options and to submit recommendations on appropriate standards, restrictions or prohibitions in connection therewith. 40 Fed. Reg. 50557.

The report of the Advisory Committee on this subject has just been completed. One of the customer safeguards which the Advisory Committee has recommended to the CFTC is that the CFTC should require that dealers of commodity options, both on and off contract markets, segregate from their general assets: (a) all money and other property received from customers, including payments for the premium on the option, but excluding commissions,

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[35] H.R. Rep. 93–975, 93d Cong., 2d Sess. at 37 (1974).

[36] The CFTC was recently constrained to urge this result in a case involving a bankrupt U.S. dealer of London options. *See* In The Matter of J. S. Love & Associates Options, Ltd., Bankrupt (United State [sic] Court, Southern District of New York, Bankruptcy No. 76B590).

and (b) any profits in whatever form, i.e., cash, cash equivalents or physical commodities, due customers on options which are in the money.[37] The Advisory Committee has indicated that it believes that any segregration program rests on the premise that the assets and profits to be segregated should be treated as the property of the customer, essentially in the same manner as futures contract margin funds of customers are treated under section 4d(2) of the CE Act.

The CFTC is in the process of evaluating the Advisory Committee's recommendations. Whether and to what extent the CFTC will endorse those recommendations I, of course, cannot predict at this time. But, as I have already indicated, the CFTC regards its segregation requirements as fundamental to the protections to be afforded commodity customers and therefore particularly welcomes the views of the Advisory Committee on this point.

Assuming the CFTC permits a particular form of option trading, precisely how the CFTC will impose segregation requirements in the transaction is an extremely complex question which depends on such matters as whether the option involved is traded on or off a contract market, whether a foreign commodiies exchange is involved, and whether there is margining of the premium. Subsumed in these matters are such issues as who is the party in the transaction who should be required to segregate and what assets should be segregated—i.e., all or part of the premium, profits accruing to the customer, the option contract itself and/or any assets obtained by the dealer to secure performance of the option. The resolution of these issues may not be the same for all forms of option trading which the CFTC may permit, and may be modified by the CFTC as it gains further insight into the trading of commodity options.

Nevertheless, Mr. Chairman, the concerns which I have already expressed concerning the need for amendment to the Bankruptcy Act to recognize CFTC segregation requirements in futures transactions apply as well to any segregation requirements which the CFTC may determine are appropriate to any particular form of commodity option trading.

I have already stated the CFTC's concerns that prevailing legal theories which trustees in bankruptcy have used are not adequate for the commodity futures industry and that specific statutory guidelines in the Bankruptcy Act are needed. The CFTC has the same concerns with respect to the bankruptcy of commodity option dealers, particularly with respect to any options which may ultimately be traded on contract markets. In addition, there is a further concern in the area of commodity options. Since there is no statutory requirement in the CE Act like that contained in section 4d(2) concerning segregation as to futures contracts, the CFTC is concerned that trustees in bankruptcy may be less inclined to apply even general trust law principles and/or tracing where segregation is required solely by CFTC regulations. Thus the CFTC believes it imperative that the Bankruptcy Act be amended to recognize the CFTC's segregation requirements which may be imposed by regulations pursuant to the CFTC's powers contained in section 4c(b) of the CE Act.

CFTC RECOMMENDATIONS

Based on the foregoing, the CFTC recommends that the Congress amend the Bankruptcy Act to provide as follows:

Where the bankrupt is any person who, in accordance with regulations adopted by the CFTC, is required to segregate from its assets any money, securities or other property received from its customers in any transactions subject to regulation under section 4c(b) of the CE Act, or any profits or contractual or other rights in whatever form accruing to such customers in such transactions:

1. *To the extent provided in such regulations, such money, securities and other property, and such profits and contractual and other rights, shall constitute a single and separate fund. Such customers shall constitute a single*

[37] On October 22, 1975, the CFTC announced that it was considering various alternative methods to regulate options. 40 Fed. Reg. 49360. On February 20, 1976, the Commission published proposed rules concerning options trading off contract markets. 41 Fed. Reg. 7774. At the time of that proposal, the CFTC invited interested persons to participate in the rulemaking process by providing comments to the CFTC. Those rules did not contain a segregation requirement, but the CFTC invited comments on whether such a requirement should be imposed.

and separate class of creditors entitled to share ratably in such fund on the basis of their net equities as of the date of bankruptcy.

2. The CFTC shall have the power, by rule, regulation or order, to specify how the net equities of any customer shall be determined, the method by which the business of the bankrupt shall be conducted after the date of bankruptcy, and the manner in which property may be specifically identified as belonging to a particular customer and returned to such customer in accordance with a ratable distribution.

3. If any such transaction was executed on a contract market designated by the CFTC, no transfer or liquidation prior to or within five days of the date of bankruptcy of an open contractual commitment entered into by the bankrupt, and no payment or release of funds prior to the date of bankruptcy by the bankrupt, shall be set aside as a voidable preference, a fraudulent conveyance, or otherwise under either state or federal law; Provided such transfer, liquidtion, payment or release was made in accordance with the rules of such contract market which have been approved by the CFTC or has otherwise been approved by the CFTC.

4. The CFTC shall receive prompt notice of the filing of the petition in bankruptcy and shall receive copies of any filings in the bankruptcy proceeding. On its application, the CFTC shall be admitted as a party, to the extent it deems appropriate, in the bankruptcy proceeding.

LEVERAGE TRANSACTIONS

Under Section 2(a)(1) of the CE Act, as amended, 7 U.S.C. 2, the CFTC is granted exclusive jurisdiction to regulate gold and silver leverage transactions subject to regulation under section 217 of the CFTC Act. Section 217 provides that:

"(a) No person shall offer to enter into, enter into, or confirm the execution of any transaction for the delivery of silver bullion, gold bullion, or bulk silver coins or bulk gold coins, pursuant to a standardized contract commonly known to the trade as a margin account, margin contract, leverage account, or leverage contract contrary to any rule, regulation or order of the Commodity Futures Trading Commission designed to insure the financial solvency of the transaction or prevent manipulation or fraud: *Provided*, That such rule, regulation, or order may be made only after notice and opportunity for hearing. If the Commission determines that any such transaction is a contract for future delivery within the meaning of the Commodity Exchange Act, as amended, such transaction shall be regulated in accordance with the rovisions of such Act."

The following description of a leverage transaction subject to section 217 is based on the nature of leverage transactions in general, and is not descriptive of the practices or policies of any particular firm or the components of any particular contract. A "leverage transaction," as it is known in the trade, involves a contract to purchase gold or silver bullion or bulk gold or silver coins pursuant to a standardized agreement prepared by a seller which I shall call a leverage transaction merchant (hereinafter referred to as "LTM"). Under the contract, the customer pays a portion of the purchase price at the outset, and agrees to buy, and the LTM agrees to deliver, a specified amount of the particular commodity at a given price, at a specified time in the future. The purchase price for the commodity is determined by the LTM in its discretion. The amount of the initial payment required varies among LTM firms. The term of the contract also varies, but may be as long as 10 years. There may be prior delivery on demand by the customer upon satisfaction of the balance due on the contract.

In addition to the initial payment toward the commodity, a customer must also pay at the outset a sales commission which is a percentage of the total purchase price. Usually, there is also imposed a "maintenance," "interest" or "finance" charge on the unpaid balance which is required to be paid over the term of the contract. This charge ostensibly represents the interest element of the LTM's cost incurred by "covering" its obligation to deliver a commodity under the contract through the purchase of the physical commodity or a related futures contract. Coverage in physical commodities generally constitutes a small portion of whatever cover the LTM effects. There also may be imposed on customers a separate storage or service fee, which ostensibly represents the storage element of the LTM's cost incurred by covering in physical commodities or futures contracts. Other charges imposed on customers include applicable taxes and, in case of delivery, a freight or similar charge.

To the extent that LTMs cover in the futures market, they are subject to margin calls if the value of the futures contract falls. LTMs often meet these margin requirements by making, in turn, a margin call upon the purchaser of the leverage contract. Currently, practice varies among LTM firms as to whether, and the extent to which, funds paid by their customers toward the purchase price of the commodity are segregated from the general assets of the LTM. The same is true with respect to the property obtained by using such funds, such as physical commodities and futures contracts.

While there is limited experience as to the frequency of delivery in leverage transactions, available data indicate that delivery occurs in only a small percentage of transactions. Rather, most contracts are liquidated prior to maturity either through the failure of a customer to make required payments or through the LTM's repurchase of the customer's interest. [In some cases, liquidation is effected by the customer selling his interest to a third party.] Typically, LTMs are not obligated to repurchase, but often accommodate their customers.

Upon liquidation due to a customer's default, the customer remains liable to the LTM for any amounts then owing under the contract. In the event the commodity in the customer's account for which he had paid has risen in value, an appropriate credit is made against such amounts.

In the event a contract is liquidated through the LTM's repurchase of the customer's interest, the customer would receive his "equity," less any amount then owing to the LTM and any applicable repurchase commission. The customer's equity will either be equal to, or more or less than, the amount paid by him toward the purchase of the commodity, depending upon the LTM's then-prevailing repurchase price for the particular commodity involved.

The Congressional mandate to the CFTC in the area of leverage transactions is clear: to assure, to the extent possible, that such transactions are regulated so as to prevent fraud or manipulation and to preserve the financial solvency of the transaction. In the case of futures contract transactions, the CFTC's segregation requirements play an important role in achieving these objectives. How segregation requirements might be employed in the area of leverage transactions was one of the considerations which prompted the CFTC, on October 30, 1975, to assign to its Advisory Committee on Definition and Regulation of Market Instruments the responsibility to study the offer and sale of leverage transactions and to submit recommendations on appropriate standards, restrictions or prohibitions in connection therewith. 40 Fed. Reg. 50557.

The report of the Advisory Committee on leverage transactions has just been completed. One of the customer safeguards which the Advisory Committee has recommended is that the CFTC should require that LTMs segregate from their general assets: (a) funds paid by customers toward the purchase price of a commodity (exclusive of separately-stated fees and charges) and (b) any property or contracts (and accrued profits thereon) obtained by using such funds, such as physical commodities and/or futures contracts obtained to cover the LTM's obligations to the customer and investments in those government obligations permitted by section 4d(2) of the CE Act. The Advisory Committee has indicated that it believes that any such segregation program rests on the premise that the funds, property and contracts to be segregated are and should be treated as those of the customer, essentially in the same manner as futures contract margin funds of customers are treated under section 4d(2) of the CE Act and the regulations thereunder.

As stated above, section 217 provides that a leverage transaction "shall be regulated in accordance with the provisions of" the CE Act if a given leverage transaction is determined by the CFTC to be a futures contract within the meaning of the CE Act. If such a determination were made, an LTM would be required to register under the CE Act as a futures commission merchant and customer funds received by this LTM-FCM would be subject to the segregation requirements established by section 4d(2) of that Act and the regulations thereunder. In such a case, of course, the CFTC's recommendations with respect to the amendment of the Bankruptcy Act as they relate to futures commission merchants and clearing houses would apply.

It is likely, however, that the CFTC will determine that one or more forms of leverage transactions, as they are presently traded or those which may be traded in the future, are not futures contracts. In such event the CFTC will adopt appropriate regulations governing these transactions and will undoubtedly impose segregation requirements on LTM's consistent with the Congressional mandate of section 217 to prevent fraud and manipulation and to preserve the

financial solvency of the transactions. Whether segregation will be required of all funds paid by customers toward the purchase price of the commodity and/or any property obtained by using such funds, such as a futures contract obtained by the LTM to cover its obligations, is a determination which the CFTC will make after it has completed its evaluation of the Advisory Committee report.

However, as in the case of commodity option transactions and futures transactions, the CFTC believes that the Bankruptcy Act must be amended to recognize the effect of any segregation requirements which are imposed in a leverage transaction, particularly since these will be solely regulatory in nature and not specfically provided for by the CE Act or the CFTC Act. As in the case of customers in futures contracts and commodity option transactions, the CFTC believes that commodity customers in leverage transactions must have their rights, as reflected in the CE Act, the CFTC Act and the CFTC's regulations, specifically recognized in the event the persons with whom they deal who are regulated by the CFTC suffer bankruptcy.

CFTC RECOMMENDATIONS

Based on the foregoing, the CFTC recommends that the Congress amend the Bankruptcy Act to provide as follows:

Where the bankrupt is any person who, in accordance with regulations adopted by the CFTC, is required to segregate from its assets, any money, securities or other property received from its customers in any transactions subject to regulation under section 217 of the CFTC Act, or any profits or contractual or other rights in whatever form accruing to such customers in such transaction:

1. *To the extent provided in such regulations, such money, securities and other property, and such profits and contractual and other rights, shall constitute a single and separate fund. Such customers shall constitute a single and separate class of creditors entitled to share ratably in such fund on the basis of their net equities as of the date of bankruptcy.*

2. *The CFTC shall have the power, by rule, regulation or order, to specify how the net equities of any customer shall be determined, the method by which the business of the bankrupt shall be conducted after the date of bankruptcy, and the manner in which property may be specifically identified as belonging to a particular customer and returned to such customer in accordance with a ratable distribution.*

3. *The CFTC shall receive prompt notice of the filing of the petition in bankruptcy and shall receive copies of any filings in the bankruptcy proceeding. On its application, the CFTC shall be admitted as a party, to the extent it deems appropriate, in the bankruptcy proceeding.*

NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS,
Carson City, Nev., February 4, 1976.

Senator QUENTIN N. BURDICK,
Chairman, Subcommittee on Improvements in Judiciary Machinery, Committee on the Judiciary, U.S. Senate, Washington, D.C.

DEAR SENATOR BURDICK: In a letter dated April 21, 1975, Judge Joe Lee, Bankruptcy Judge for The United States District Court for the Eastern District of Kentucky, took issue with the National Association of Insurance Commissioners' (NAIC) recommendation to continue the present exemption for insurance companies from the federal rules governing voluntary and involuntary bankruptcy petitions. You may recall that the NAIC consists of the principal regulatory authorities of the 50 states, Guam, Puerto Rico and the Virgin Islands. This letter is submitted as a supplement to our letter on February 20, 1975, a copy of which is enclosed for your convenience. Several reasons strongly support the nonapplication of the federal bankruptcy law to insurance companies.

1. THE CONCEPT OF FEDERALISM

Today, even more so than in the past, we should start from a position of general reluctance to support unnecessary federal encroachment in any area being handled in a reasonably satisfactory manner by the states. In our system of a federal form of government, a wide dispersion of political power is fundamental. In this context, any application of the federal bankruptcy law

to insurance poses difficult problems in delineating between the federal bankruptcy system and the state insurance regulatory system.

Every bankruptcy proceeding inevitably intrudes deeply into the system of state regulation, since the institution of a proceeding is itself inherently the most important of all regulatory acts. The intrusion should be limited so far as possible.[1]

Furthermore, because of the activity of the states (1) in preventing insolvencies (e.g., capital and surplus requirements, investment limitations, disclosure, examinations, computerized early warning system on financial condition), (2) in protecting against the adverse consequences of insolvencies through guaranty funds, and (3) in improving liquidation and rehabilitation laws, the arguments for federal involvement have become progressively less apropros. In fact, federal involvement could be viewed as a step backward to the extent it adversely impacts on the ability of the states to handle insolvency situations as they arise.

2. ADVERSE IMPACT ON THE ABILITY OF STATE REGULATORS TO PROTECT THE PUBLIC

The intrusion of federal law into the insurance bankruptcy area should be avoided not only from the viewpoint of maintaining the fundamental concept of federalism, but also from the viewpoint of the adverse impact on the ability of the states to better protect the insurance-consuming public. Under existing state statutes, insurance commissioners are given a great deal of discretion to determine the feasibility of instituting liquidation or rehabilitation proceedings against an insurer. The grounds for such proceedings are specifically spelled out in state insurance codes and range from quite detailed requirements—such as the failure to file an annual report—to a broad and general finding that "the insurer is in such condition that the further transaction of business would be hazardous, financially or otherwise, to its policyholders, the creditors, or the public."[2] In addition, insurance commissioners can invoke a number of alternative remedies to meet different situations. In many instances the commissioner is able to work out means to save in insurer to the benefit of policyholders, beneficiaries, claimant, creditors, etc. The key ingredient to any such success, however, is flexibility. The complex relationships between policyholders, insurers and creditors demands no less. If involuntary petitions in bankruptcy are allowed to be filed in federal courts, there will be an unnecessary intrusion on the flexibility of insurance regulators. A regulatory cannot function in this complex area if premature bankruptcy actions pose a a constant threat to his control of a delicate insolvency situation. In short, overriding the recommendations of the National Commission and accepting those in the Judges' bill would severely impair the ability of state insurance regulators to protect the rights of policyholders, insurance companies and creditors when potential and actual insolvencies occur.

3. INTERRELATIONSHIP OF REGULATORY TOOLS

A fundamental goal of insurance regulation is to enhance the reliability of the insurance product. This is achieved through insolvency prevention, liquidation and rehabilitation laws, and the guaranty fund mechanism. Decisions regarding the desirability of applying one of these techniques is influenced by the availability and applicability of the others. The intervention of third party petitions in bankruptcy would therefore significantly upset the functioning of these interrelated regulatory tools.

4. POTENTIAL DISASTROUS CONSEQUENCES DURING ADVERSE ECONOMIC PERIODS

In our letter of February 20, 1975, we noted that "Congress expressly exempted insurance companies from the Federal Bankruptcy Act, recognizing that insurers are organized under state statutes, and subject to a comprehensive system of state regulation including rules governing insolvency." Judge Lee has challenged this assertion as one that overlooks the fact that all domestic corporations are created and regulated under state law, and "[t]he argument that corporations, being creatures of state law, should not

[1] Spencer L. Kimball, Memorandum about Subjection of Insurance Companies to Federal Bankruptcy Law, 1975 (unpublished memorandum).
[2] E.g., WIS. STAT. § 645.41 (1973).

be dissolved in bankruptcy proceedings was put to rest a century and a half ago." The viewpoint of Judge Lee in fact underscores a fundamental point that must be recognized when considering the theoretical applicability of the federal bankruptcy laws. The point is that an insurance company is not simply another domestic corporation organized and regulated under state law.

Insurance companies are financial institutions, quasi-public in nature, that operate to provide part of the financial security that must underlie a healthy economy. Neither the states nor the federal government are particularly concerned with the solvency of most types of individual business concerns. Those that fail may in fact have a healthy, purging effect in an economy based upon the competitive market mechanism. Regulatory treatment of financial institutions, however, must recognize the fundamental characteristics which sets them apart from other business concerns. An insolvent and failing insurance company can have complex ramifications that go far beyond simply adverse consequences for creditors. Protection of policyholders and their beneficiaries and the guarantees of economic security are of utmost importance.

Perhaps the most dangerous feature of the Bankruptcy Judges' proposal to subject insurance companies to bankruptcy proceedings is that it would permit individual federal bankruptcy referees throughout the country to make determinations of the solvency of insurance companies and throw them into bankruptcy during adverse times. During the Panic of 1906–1907, and again in 1932, at the height of the Depression, the NAIC, as the coordinating agency between the states, promulgated so-called convention values for the assets of insurers. If the securities of the insurers at that time had been appraised at market value most of the insurance companies in the United States would have been insolvent. By valuing these securities under the NAIC guidelines, however, the insurance business and its millions of policyholders were saved. Consequently, the valuation procedures available today, as well as those employed in times of economic uncertainty, are regulatory tools that should not be employed without consideration of other numerous regulatory concerns.

Speaking in generalities, there is little reason to look at the assets of insurance companies in terms of their liquidation value on a particular day. The NAIC has long been concerned with the maintenance of valuation procedures that recognize the fair and intrinsic value of insurance company investments apart from the day-to-day fluctuations of market values in the securities exchanges. For example, bonds are typically amortized rather than carried at market value for valuation purposes. Insurance companies that are sound, going concerns with competent management and portfolios filled with high grade securities should not be subject to bankruptcy proceedings as a result of a technical insolvency resulting from stringent monetary conditions, securities market panics and wide market price fluctuations.

This is not to say that market values of insurers' investments are not of interest to insurance regulators. Rather, the nature of in insurance business is such that the maturing of contractual liabilities to policy-holders resulting from fortuitous losses are, in the aggregate, predictable and virtually unrelated to the prevailing economic conditions of the nation and its securities markets.

During the Depression President Roosevelt was forced to close the nation's banks. Severe measures such as this were not necessary in the insurance business, however, because of the exercise of the valuation powers of the states. As recently as 1974, due to the market increase in interest rates, many insurers would have exprerienced financial difficulties similar to those of the 1930's if their existing block of bonds were valued at market price. Bankruptcy lawyers could have seized upon this as an excuse for throwing insurance companies into bankruptcy even though the condition of the insurers was a temporary one and could be expected to work out in a normal way over the course of time. This is an example of how unified state regulation works and emphasizes why insurers—who provide a social form of coverage for millions of Americans—should not be exposed to the vagaries of a variety of actions permitted under the bankruptcy laws.

5. PREMATURE ELIMINATION OF THE EXEMPTION

The insurance business is a complicated business which affects the lives of millions of people. Over a long period of time a comprehensive system of state insurance regulation has evolved to meet the challenges presented by this complex business. Since eliminating the insurance exemption from the federal

bankruptcy laws would significantly affect insurance regulation, such action should not be attempted in the absence of a thorough review of the consequences which would follow, or specifically, particular attention should be focused on the relationship between the unique nature of the insurance business and its regulation and existing federal bankruptcy procedures. Adapting the existing federal bankruptcy framework to the needs of the insurance-consuming public could be a very substantial undertaking which would probably require a separate chapter in the bankruptcy law. In contrast, the deletion of the exemption in the Judges' bill makes no effort to tailor the present bankruptcy provisions to the insurance situation.

6. ABSENCE OF PRESSING NEED

We think it fair to say that Judge Lee's letter, in essence, raises only one substantive objection to current state practices, regarding insurance company insolvencies. That is, liquidation and rehabilitation of insurance companies of an interstate character sometimes poses a jurisdictional problem. The uncertain authority of the receiver in nondomiciliary states, the need for ancillary proceedings in some instances and conflictuing priority rules may cause some difficulties for receivers of a multi-state insolvency. Although Judge Lee made some additional periphery comments, we would like to focus on this contention.

At least on a theoretical basis, there is little doubt that the limited jurisdictional reach of state courts, as contrasted to the federal courts, may render it more difficult for the principal receiver to reach the assets and administer the insolvency of a multi-state insurer. But to a certain extent this problem is mitigated by the Uniform Insurers Liquidation Act promulgated by the National Conference of Commissioners on State Laws.[3] Admittedly, the Act did not solve all interstate problems in liquidation cases. Although its purpose was to secure equal treatment of all creditors wherever situated, a number of its provisions were binding only upon those states which adopted it. In recent years efforts have been made to improve the Act's provisions. But even more important that the Uniform Act is the interrelationship between the personnel of state insurance departments who are responsible for administering the insurance liquidation and rehabilitation laws. Because of the rapport and communication between such persons, the potential conflicts between nonreciprocal states are minimized, although admittedly not eliminated.

It should also be noted that, according to Judge Lee, the bankruptcy judges support the continued bankruptcy exemption for banks and building and loan associations since their deposits are insured by federal deposit insurance. Similarly, virtually all states have enacted guaranty fund legislation for property and liability insurers and several states have done so for life and health insurance.[4] Thus, applying the bankruptcy judges' own rationale leads to the continued exemption for insurers. Furthermore, several state guaranty fund laws not only provides a source for the payment of the obligations of an insolvent insurer to policyholders and beneficiaries, but also in many instances enable the state guaranty fund association, under the supervision of the insurance commissioner, to exercise control over an insurer's assets before a petition of insolvency is filed. In these cases no ancillary liquidation proceedings are necessary because the insurer can "voluntarily" liquidate or rehabilitate itself under supervision of the insurance commissioner and the auspices of the state guaranty fund association.

Thus, even though the existing state system of treating interstate problems of insurer insolvencies lacks complete theoretical neatness, it does provide an ongoing, workable system which continues to evolve. Other than Judge Lee's letter, we are not aware of any widespread advocacy to eliminate the present insurance exemption from existing bankruptcy laws. This would seem to suggest a reasonably satisfactory performance by the states and an absence of a substantial need to apply the federal bankruptcy law to the insurance business.

One final point needs to be made. Judge Lee suggested that, at the very least, insurance commissioners should have the option of applying to the fed-

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[3] The NAIC and several insurance departments cooperated in the preparation of this Act. The Act sought to solve the interstate problems by providing, among other things, for the transfer of assets of an insolvent insurer located in various states to the primary receiver in the state of domicile and by providing for reciprocity in handling receiverships among adopting states.

[4] Life and health insurers are less susceptible to insolvency and few life and health policyholders have been injured due to an insolvency.

eral bankruptcy court for appointment as trustees to obtain the benefits of a nationwide jurisdiction. However, the Judges' bill in no way limits the applicability of the bankruptcy laws to situations in which the state insurance commissioner possesses the sole discretion and authority to make use of the federal courts.

7. SUMMARY

The NAIC supports the continuance of the present exemption of insurance companies from the rules governing voluntary and involuntary bankruptcy petitions. We urge that section 4–201 and 4–204 of S–236 (Commission's bill) be enacted, while sections 4–201 and 4–204 of S–235 (Judges' bill) be rejected. To do otherwise would:

(1) Impinge upon the fundamental objective of a viable government based upon the concept of federalism,

(2) Adversely impact on the ability of the states to prevent insolvencies,

(3) Interfere in the relationship between various insurance regulatory tools,

(4) Pose potential disastrous industry-wide consequences during adverse economic periods,

(5) Fail to tailor bankruptcy proceedings to the unique nature of the insurance business, and

(6) Radically alter the existing legal framework in the absence of a pressing need.

The determination of the National Commission on Bankruptcy to retain the present exemption for insurance companies is not only the result of sound reasoning and good judgment, but is consistent with the broad congressional policies underlying the McCarran Act.[5]

Your consideration of these comments supplementing those of February 20 is greatly appreciated.

Sincerely,

/s/ Dick L. Rottman
DICK L. ROTTMAN,
President.

/s/ Lester L. Rawls
LESTER L. RAWLS,
Chairman of Executive Committee.

Enclosure.

NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS,
Des Moines, Iowa, February 20, 1975.

Re Federal Bankruptcy Bills S–235, S–236

Senator QUENTIN N. BURDICK,
Chairman, Subcommittee on Improvements in Judicial Machinery, Dirksen Office Building, Washington, D.C.

DEAR SENATOR BURDICK: This letter is submitted on behalf of the National Association of Insurance Commissioners. The NAIC is a voluntary association of state insurance regulatory officials. The membership consists of the fifty states, the District of Columbia, Guam, Puerto Rico and the Virgin Islands. The NAIC is the oldest association of its kind, having been in existence since 1871.

In addition to S–236 which the National Commission on the Bankruptcy drafted for its report to Congress, we understand that the National conference of Bankruptcy Judges have formulated their own proposal which was introduced in the 94th Congress as S–235. The primary purpose of this letter is to draw your attention to certain provisions in S–235 which are of concern to the NAIC and the state regulators of insurance.

The provisions of S–235 which are of particular concern to state insurance regulators are Sections 4–201 (Debtors Eligible for Voluntary Relief) and 4–204 (Debtors Subject to Involuntary Relief). These provisions remove the statutory exception for insurance companies from the rules governing voluntary and involuntary petitions. This departs not only from the existing Bankruptcy Act, but also from the Commission's proposal (S–236) which would continue the exemption.

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[5] "Congress hereby declares that the continued regulated and taxation by the several states of the business insurance is in the public interest * * *." 15 U.S.C. § 1011 (1970). The Supreme Court, when considering the McCarran Act, said, "obviously Congress' purpose was broadly to give support to the existing and future state systems for regulating and taxing the business of insurance." Prudential Ins. Co. v. Benjamin, 328 U.S. 408, 429 (1946).

Congress expressly exempted insurance companies from the Federal Bankruptcy Act recognizing that insurers are organized under state statutes, and subject to a comprehensive system of state regulation including rules governing insolvency.

The role of state insurance regulation on solvency and liquidation of insurers is a long standing one. State insurance regulation focuses on the financial condition of an insurer, and state procedures for liquidation and rehabilitation are an integral part of this state regulation. The desirability of continued state regulation is further enhanced by the fact that states have an existing and effective mechanism for protecting the public against the risk of insurance company insolvencies. If the bankruptcy laws were to be revised consistent with S–235, the newly created federal involvement in the insurance bankruptcy area would overlap and conflict with the role of the states and would upset a whole body of existing laws. In addition, the application of federal bankruptcy proceedings to insurance companies would adversely affect policyholders in at least two respects: (1) The federal law emphasis on creditors may result in policyholders being in a less favorable position and (2) protection afforded policyholders under state guaranty fund laws could be jeopardized.

The NAIC has developed and adopted a series of model laws for the use and guidance of the various states including a model rehabilitation and liquidation law, model legislation imposing criminal sanctions for failure to report mpairment, and regulations pertaining to ceded reinsurance as it bears on potential insolvencies. Beyond the matter of model legislation and regulation, the NAIC has created a data bank which provides support to the several state insurance departments in detecting and dealing with potential insolvencies. The data bank includes annual statement data of some 2900 companies. For more than three years, the NAICC has had an early warning system in effect which focuses state insurance departments' attention on companies that may need remedial attention. The NAIC provides, through its Financial Condition, Examination and Reporting Committee, a coordinated machinery for conducting examinations and Reporting Committee, a coordinated machinery for conducting examinations of insurance companies. The NAIC maintains a New York office for valuation of securities held in the portfolios of virtually every insurance company in the United States, and has the power to change the valuations procedures on a country-wide basis in periods of national economic emergency.

In short, S–235 would involve a fundamental change in a complex and ongoing system of state insurance regulation if insurance companies were to be subjected to Federal bankruptcy laws as a result. Such a drastic shift in the nature of the federal versus state regulatory role in insurance matters is not warranted by reason or circumstance. In any event, the desirability of this particular intervention should be considered in terms of the effect on the overall regulatory system.

In 1945 Congress declared in the McCarran Act that "continued regulation by the several states of the business of insurance is in the public interest * * *." (15 U.S.C. § 1011) Furthermore "(n)o act of Congress shall be construed to invalidate, impair or supersede any law enacted by any state for the purpose of regulating the business of insurance * * * unless such Act specifically relates to the business of insurance." (15 U.S.C. § 1012)

It is not clear in reading S–235 whether that bill contemplates making the proposed bankruptcy act applicable to insurance companies or not. Since S–235 does not specifically relate to the business of insurance, it would appear that the McCarran Act creates its own exemption for insurers under the Bankruptcy Act (or any other federal law). But the elimination of the specific exemption in the Bankruptcy Act would be subject to the argument of some that Congress, in eliminating the specific exemption, meant to subject insurers to the new Federal bankruptcy legislation. In order to eliminate any ambiguity, we strongly recommend the S–235 as well as other bankruptcy reform measures include a specific exemption for insurers consistent with the position of the National Commission on Bankruptcy Laws.

We appreciate the opportunity to submit our comments to you.

Sincerely,

WILLIAM H. HUFF III,
President.
DICK L. ROTTMAN,
Vice President,
Chairman of the Executive Committee.

INTERSTATE COMMERCE COMMISSION,
OFFICE OF THE CHAIRMAN,
Washington, D.C., May 10, 1976.

Hon. QUENTIN BURDICK,
Chairman, Subcommittee on Improvement in Judicial Machinery, Committee on the Judiciary, U.S. Senate, Washington, D.C.

DEAR CHAIRMAN BURDICK: I understand that your Subcommittee is currently considering two bills which would make comprehensive revisions in the laws that govern bankruptcies. The first of these, S. 235, is the proposal of the National Conference of Bankruptcy Judges and the second, S. 236, was recommended by the National Commission on the Bankruptcy Laws of the United States. Chapter X of S. 235 and Chapter IX of S. 236 would provide new procedures and standards for railroad reorganizations.

The Interstate Commerce Commission, which has a vital role to play in railroad reorganizations under section 77 of the Bankruptcy Act, is very interested in the progress of this legislation and has commented extensively on substantially identical legislation before a House Committee. For the Subcommittee's information, I have enclosed a copy of our testimony before the Civil and Constitutional Rights Subcommittee of the House Committee on the Judiciary on H.R. 31, which is substantially identical to S. 236, and H.R. 32, which is substantially identical to S. 235.

Although the Commission has not yet been asked to comment on the Senate bills, we thought you should be aware of our interest in this area, and of our analysis and position on the provisions of the parallel House bills that relate to railroad reorganizations. If there is any additional information we can supply which would be useful to you or your staff, please let me know.

Sincerely yours,

GEORGE M. STAFFORD,
Chairman.

Enclosure.

STATEMENT OF GEORGE M. STAFFORD, CHAIRMAN, INTERSTATE COMMERCE COMMISSION, ON H.R. 31 (S. 236) AND H.R. 32 (S. 235)

Mr. Chairman, Members of the Subcommittee: I am pleased to be here this morning on behalf of the Interstate Commerce Commission to discuss with you certain provisions of H.R. 31 and H.R. 32, two bills which would make comprehensive revisions of the laws that govern bankruptcies. The first of these, H.R. 31, is the recommendation of the National Commission on the Bankruptcy Laws of the United States. That Commission, established pursuant to Public Law 91–354, was directed, among other things, to recommend changes in the present Bankruptcy Act, which would reflect and adequately meet the demands of current technical, financial, and commercial activities. The accompanying report of the Commission explains the amendments made to the present law by H.R. 31 and the reasons therefor.

Chapter IX of the bill replaces section 77 of the Bankruptcy Act and provides new procedures and standards for railroad reorganization cases. Since the Commission is charged by Congress with the economic regulation of railroads and since we have a major role to play in railroad reorganizations under section 77, my comments on H.R. 31 will be directed principally to Chapter IX.

The second bill before your Subcommittee, H.R. 32, was proposed by the National Conference of Bankruptcy Judges. Chapter X of the bill contains revisions dealing with railroad bankruptcies which are similar in approach to those contained in H.R. 31. My remarks on H.R. 32 will be directed primarily to those provisions of chapter X that differ from chapter IX of H.R. 31.

The Interstate Commerce Commission agrees that there is a need for revision of section 77 of the Bankruptcy Act, and we commend the Commission on Bankruptcy Laws for its thorough analysis of current procedures. We do not believe, however, that with regard to rail reorganization cases, the report identifies the central issue, nor do we think that it provides adequate answers to the questions that it does properly raise.

The basic issue as we see it is whether section 77 is an adequate mechanism to resolve the modern day problems of multiple bankruptcies in a region and bankrupt railroads that are not producing enough revenue to meet operating expenses. Section 77 clearly was not adequate to meet these problems as they arose from the multiple railroad bankruptcies in the Northeast during

the last decade. This led to the passage of the Regional Rail Reorganization Act of 1973, which, through governmental planning and infusion of Federal funds, created a new railroad, the Consolidated Rail Corporation (ConRail) out of six bankrupt railroads. ConRail is a somewhat streamlined version of the bankrupt roads which, through the reduction of light density lines, new management and substantial Federal funding for facilities improvement, is intended to turn a profit by 1980. To some extent, the planning and funding mechanisms of the Regional Rail Reorganization Act of 1973 have been extended nationwide by the Railroad Revitalization and Regulatory Reform Act of 1976 (Public Law 94-210). This Act provides both for a study of the Nation's railroad system and how it can be streamlined and for funds to be distributed in accordance with the results of that study. It also establishes expedited procedures for the approval of railroad mergers and provides a mechanism whereby Federal and local funds can be used to subsidize money losing branch lines.

All of these features are intended to produce a more viable railroad system, and thus their goals are similar to those of a section 77 reorganization. It seems to us that no revision of section 77 would be complete without taking into account the major railroad legislation of 1973 and 1976 and without making an effort to coordinate the provisions of section 77 with this new rail legislation. The revisions to section 77 contained in H.R. 31 and H.R. 32 are deficient in that they do not address the new rail acts, and after discussing the issues that they do address, we will make some suggestions for additions to, along with revisions of, the provisions of H.R. 31 and H.R. 32.

The main thesis of the Bankruptcy Commission Report is that rail reorganization cases under section 77 take too long and involve too much duplication of effort between the courts and the ICC. We generally agree with this thesis, but we do not agree with the Report's approach to solving this problem, which is to increase the decision making role of the courts in rail bankruptcies and to relegate the ICC to a mere advisory role. This approach tends to preserve and accentuate some of the worst aspects of present section 77.

Decreasing the role of the ICC and increasing the role of the courts makes little sense since the ICC is not primarily responsible for delays in reorganization cases and since more, rather than less, emphasis should be placed on transportation expertise in rail reorganization cases.

Concerning the question of delay in reorganization cases, the fact is that undue time is consumed in court litigation years before the ICC gets the case. While section 77(d) of the Bankruptcy Act requires that the debtor submit a plan of reorganization within six months of the entry of the judge's order approving the bankruptcy petition as properly filed, the court may in its discretion, and usually does, grant extensions of time. The real delay in bankruptcy proceedings is in the length of time taken to get a plan of reorganization before the ICC, not in the length of time taken by the ICC to act on the plan or to satisfy its other obligations under the Act.

The most obvious and recent examples of this delay will be found in the reorganization proceedings of the railroads in the Northeast and Midwest region of the country which were ultimately reorganized under the provisions of the Regional Rail Reorganization Act of 1973. Reorganization petitions for these carriers were filed as early as 1967, for the Central Railroad Company of New Jersey; in 1970 for the Penn Central Transportation Co.; in 1970 for the Lehigh Valley; in 1971 for the Reading; in 1972 for the Erie Lackawanna; and in 1973 for the Ann Arbor. Of these, only in the Penn Central proceeding was a reorganization plan ever filed, and in that case it took over three years to produce what was really a plan of liquidation which was rejected by the Commission. The Chicago, Rock Island and Pacific Railroad has been in reorganization for over a year, and no reorganization plan has as yet been filed. In an earlier Rock Island bankruptcy, incidentally, during the early 1930's, it was over three years following the filing of the petition before a plan was submitted.

In the lengthy periods between the filing of the petitions and the completion of the plans, there has been endless litigation mainly before the courts about matters related to creditors' rights, erosion of the estates, claims, administrative expenses, etc., but very little on development of a reorganization plan. Little, if any, of this delay would be eliminated by removing the ICC from meaningful decision making functions in reorganizations as the proposed bills would do.

Not only is expanding the role of the judiciary in transportation aspects of rail reorganization cases unwarranted from the standpoint of eliminating delays, it also appears to us to be going in the wrong direction in terms of producing decisions that will lead to a better, financially sound railroad system. The proposal transfers primary responsibility for many substantive matters from the ICC to the court when it is the ICC that has the expertise to rule in such areas as abandonments, operations and maintenance, reorganization plans, and issuance of securities. This approach is a step backwards to over 40 years ago when it became evident that the court lacked the administrative expertise required in railroad reorganization and the ICC was vested with the authority to make certain substantive determinations. While section 77 is in need of improvement, the thrust of any amendment should be toward less judicialization of the process, not more.

Here again, after analyzing the provisions of the bills, we will make some alternative suggestions for changes in the present section 77 that we think will produce some improvements. But at this point, we do want to emphasize our disagreement with the Bankruptcy Commission's view that the essential purpose of section 77 is the protection of the creditors' rights (Report at p. 263). As the Supreme Court emphasized in the *New Haven Inclusion Cases*, 399 U.S. 392, 491–92 (1970), railroad reorganizations must involve equal consideration of the public's interest in continued rail service and the constitutional issue involved in protecting the creditors' rights. It is because of the importance to the Nation of a viable railroad system that the Commission must play the primary role in approving plans to reorganize individual segments of that system.

I want to make clear that the ICC does not view the creditors' rights as secondary. To the contrary, we recognize that a sound, viable railroad system under private ownership requires the confidence and support of the financial community, and in that sense, careful protection of creditors' rights under the laws and the Constitution goes hand-in-hand with, and is an integral part of, the public interest.

It is these public interest factors that render inappropriate the Bankruptcy Commission's analogy of the ICC's role under its proposal to the SEC's advisory role in ordinary corporate reorganizations. Railroad bankruptcies are special because the Nation's rail network is truly a system on which the Nation depends for its survival and the ICC's mandate is to foster a sound transportation system. Thus. in order to ensure that essential rail service is available to the public, the ICC's mandate is to foster a sound transportation system. Thus, in order to ensure that essential rail service is available to the public, the ICC's decision-making role in the reorganization process should be maintained.

The analogy is weak in another respect. The regulatory responsibility of the SEC is limited to matters affecting the capital structure of a corporation and does not include a role in the corporation's actual operations. The ICC, on the other hand, is involved with matters affecting the actual operations of rail carriers and thus has a special expertise which should be put to use in railroad reorganizations. The courts are often strangers to railroad operations and finances, and they lack the staff necessary to deal with complex railroad problems. The ICC has the expertise and the staff to cope with these problems, and these resources should be fully utilized in the reorganization process.

The Commission's expertise goes beyond its familiarity with railroad operations which would stand it in good stead in passing on the impact of a reorganization plan upon the particular railroad in reorganization and its ability to continue to provide needed public services. We are also aware of, and concerned about, the operations and services of carriers other than the bankrupt which compete with it or connect with it. Their services, too, could be affected by the reorganization, and the Commission would be in a better position than most courts to evaluate these effects.

H.R. 31

I will now turn to some of the major provisions of H.R. 31 and discuss how they will affect the role of the InterState Commerce Commission in rail bankruptcy proceedings and the processing of rail reorganizations in general.

REORGANIZATION PLANS

First, in the important area of rail reorganization plans, the Bankruptcy Commission's proposal would virtually eliminate the ICC's responsibility with respect to the formulation of the basic plan and give us merely an advisory role.

As section 77 now stands, the Commission passes upon any plan of reorganization in the first instance, following the simultaneous filing of the plan with the Commission and the court. (§ 77(d)). The reorganization court approves or disapproves the plan certified by the Commission, which may differ from any proposed. (§ 77(e)). If the court disapproves the plan, it can either dismiss the proceedings or refer the matter back to the Commission. Following court approval of the initial or modified plan, the Commission submits the plan to the security holders for a vote, and the results of that vote are certified to the court. The judge then confirms that plan if more than two-thirds of each class of security holders entitled to vote accepts the plan. If such acceptance is not forthcoming, the court may, nevertheless, approve the plan if it provides fair and equitable treatment of those rejecting it and their rejection is not reasonably justified.

A basic part of any reorganization plan is the valuation of the debtor's property. See *New Haven Inclusion Cases*, 399 U.S. 392, 434 (1970). Section 77(e) places the burden of property valuation on the Commission as part of its responsibility in the development of a reorganization plan.

This entire process would be changed by Part 5 of Chapter IX of H.R. 31 which would require that the trustee submit a reorganization plan to the court only. The court would then submit the plan to the ICC for the preparation of an advisory report to be filed within a specific time limit. Upon the filing of that report, or upon the expiration of the deadline, the court is directed to submit the plan to the stockholders, who may file objections. The court must then hold a hearing and determine whether the plan meets the criteria set out in the statute.

The Bankruptcy Commission's Report states (at p. 269) that the key tests of whether a plan satisfies the statute are largely unchanged. This does not appear accurate. The new standards (sections 7–310(d) and 9–503(d)) provide inter alia, that in order to be confirmed, the plan must be accepted by a majority of creditors in each class materially and adversely affected and if the debtor is not insolvent, the plan must also be accepted by the holders of a majority in number of the equity securities of each class materially and adversely affected; that there is a reasonable probability that the consideration distributed under the plan will fully compensate the respective classes of creditors and equity security holders of the debtor; that it provides for the payment of various expenses and debts listed in section 7–303(2) and 9–503(d); and that the plan is compatible with the public interest. When these standards are compared with the standards contained in sections 77(b), (d), and (e), it is clear that the present standards for creditor and stockholder compensation are considerably more flexible than those proposed and that the court would no longer be able to confirm any plan unless the creditors and stockholders approve.

The Bankruptcy Commission Report states that these changes provide a more efficient way to handle the plans and a speedier confirmation process. But we cannot see how the framework set up by this legislation will provide for a more expeditious achievement and finalization of a plan. First, as noted earlier, the real delays are not so much in the confirmation process as in the waiting for the submission of a plan in the first instance. There is nothing in this legislation that would deal with this, the major problem. And second, the conditions which the plan must satisfy are extremely demanding, if not totally unrealistic. The trustee must come up with a feasible proposal that will fully compensate the creditors and stockholders and win their approval while at the same time meeting the public's interest in an adequate transportation system. Given the great difficulty in achieving these goals, it would appear that more, rather than less, time would be needed to formulate an acceptable plan.

At best, the vital term "fully compensate," as used in section 7–310(d), is ambiguuous. It could well be construed to require provision of 100 cents on the dollar to both creditors and stockholders, a task which may be virtually impossible. Normally, "reorganization" connotes changes in the debt structure and physical configuration of the railroad which result in an income-producing

entity capable of servicing the debt, providing a return on equity, and maintaining essential service to the public. This, in all likelihood, would require a scaling down of the debt structure and issuance of new securities designed to make only the creditors whole over a period of time.

Although the proposal would not expedite the process, it would introduce into railroad reorganization law an escalation of private rights, as compared to the equality between private and public interest recognized by the Supreme Court in the *New Haven Inclusion Cases, supra.* While the ICC, one of whose primary concerns is the adequacy of rail service available to the public, is reduced to the role of a mere advisor whose determinations may be ignored, a majority of the creditors and stockholders are vested with a final veto over any reorganization plan if they perceive that it does not fully satisfy their private interest. We believe that this approach denied sufficient weight to the public interest in the rail reorganization process.

Under the present state of the law, those who invest in railroad securities do so with the knowledge that, in the event of bankruptcy, their interests will be weighed on a par with the public's interest in continued rail service. The proposal would destroy this equality and create a bias in favor of the private investor. If the result of this tilt in the equities were to attract capital to the railroads, we might find it easier to understand, but there is no evidence to justify it on that ground.

The public interest is also given short shrift in that under the procedure set forth in section 9–503, plans are to be submitted to the ICC for examination and preparation of an advisory report under a court-established deadline, and then returned to the court. The creditors and equity security holders are then notified and given an opportunity to object, and the court must then hold a hearing to consider the plan and objections thereto. Obviously, the focus of this hearing will be how the plan suits the immediate interests of creditors and equity security holders, yet there is no provision for a hearing before the Commission to determine the feasibility of the plan in terms of railroad operations and the transportation needs of the communities affected. Thus the Commission, with its particular expertise in railroad reorganization and operation, would not only be deprived of the authority to rule on the plan and to modify it in the public interest, it would not even be given the opportunity to develop the information necessary to determine what the public needs are, and to make informed recommendations to the court.

The proposal's tilt away from the public interest is further aggravated by the fact that although the ICC, the Department of Transportation and State regulatory commissions may appear in reorganization cases, they may not appeal from any judgment or order entered in such case. Thus, those public bodies entrusted with the duty of maintaining an adequate transportation system are precluded from appealing decisions that would necessarily be geared to standards which ignore the public's transportation needs. We believe that it is imperative that the ICC be able to represent the public by appealing court decisions that prevent it from carrying out its mandate, particularly if the Commission is to be deprived of any decision-making authority in the first instance.

In sum, the provisions of H.R. 31 that establish the standards, hearing procedures, and appeal procedures for the formulation of reorganization plans, modify the present reorganization process so as to create a new legal quality to the rights of creditors to the jeopardy of the public's interest in transportation. We strongly suggest that any modification should maintain the present balance between the private and public rights and the interrelationship between the two; and should establish more effective procedures for achieving that objective. Our suggestions for such modifications are set forth later in this statement (at page 23).

ABANDONMENTS

The proposed legislation would also change the process for handling proposed abandonments of rail carriers in reorganization. Under present section 77(o), the judge may authorize the abandonment, after hearing, but only with ICC approval. Under section 9–403 of H.R. 31, the court may authorize the abandonment regardless of whether the Commission has approved it or not.

The new section would provide that where ICC approval of an abandonment would otherwise be necessary, the trustee with the approval of the court, shall first initiate a petition with the ICC. The court will then impose

a time limit during which the Commission must render its decision. If no decision is issued within that time, or if the ICC denied the application, the court may grant the application.

The report of the Bankruptcy Commission offers as the rationale for this change the elimination of "undue delays in the processing of abandonments by the Interstate Commerce Commission. Further, the report states (at p. 269) that this amendment is consistent with present section 77(o) in that the ICC has the initial responsibility for determining the matter; if the Commission fails to act within the time limit set by the court, then the court may decide on the petition.

As to the assertion that there are inordinate delays in ICC processing of abandonments, I would like to point to some statistics for our abandonment cases for the years 1960 through 1970. During this period the average time taken to process a case from the date of designation (the date on which the applicant has filed with the Commission all the material required for us to begin to process the application) to the date of decision was 4 months. For those abandonments which were unopposed and thus could be decided without hearing, the average time from the date of designation to the date of decision was one month. This does not appear to us to constitute an undue delay.[1] Furthermore, sections 303 and 802 of the new Rail Act, Public Law 94–210, impose deadlines on all phases of ICC abandonment cases, thus ensuring expeditious consideration of abandonment applications.

Also, we believe that the portion of the Bankruptcy Commission's Report which states that the new abandonment provisions are in conformity with present section 77(o) and suggests that it is only when the ICC fails to act within the time set by the judge, that the court will step in and decide on the petition, is misleading. In fact, under section 9–403, the court may grant the application even if the Commission has ruled within the deadline and has denied the application. Thus, the court can decide on the issues itself whether or not the ICC has acted within the time limit, and the ICC is relegated to the position of a mere advisor whose views can be ignored.

In the area of abandonments, the issues presented are essentially transportation matters within the particular expertise of the Interstate Commerce Commission. They involve questions of the carrier's capacity to continue operations as well as the public need for service, the adequacy of alternative service, and various other economic, social, and environmental considerations. Our long experience in handling abandonment cases has given us a greater understanding of national and regional transportation issues than the district courts and thus a better view of how any given abandonment affects the local, regional, or national transportation system. Since abandonments involve matters which the Congress has specifically delegated to the ICC, we believe that we should play the same role in the processing of abandonments of bankrupt carriers that we play with regard to abandonments by other rail carriers.

SECURITIES

The proposal would also change the law with respect to the issuance of securities by the debtor or trustee. Under present section 77(c)(3) of the Bankruptcy Act, ICC approval is required before the judge may authorize their issuance. Under section 7-106 of the bill the debtor or trustee could issue certificates upon the approval of the Administrator (who, pursuant to section 9–102, would be the district court judge) without the approval or advice of the ICC. The Report of the Bankruptcy Commission gives no rationale for this change, providing, in effect, that entering into bankruptcy suspends section 20a of the Interstate Commerce Act, which was intended to protect both present and prospective investors in the carrier. Again, the bill would remove the ICC from participation in an area where we have developed a special expertise which should be put to use, and revert to the approach which proved unsatisfactory years ago.

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[1] The Commission's abandonment procedures were brought to a virtual halt by an injunction issued in *Harlem Valley Transportation Ass'n.* v. *Stafford*, 360 F. Supp. 1057 (SDNY 1973), aff'd 500 F.2d 328 (2nd Cir. 1974). That case dealt with the Commission's compliance with the procedural requirements of the National Environmental Policy Act. Now that the case has been resolved, the Commission's abandonment processes are again functioning smoothly at an expedited pace.

APPOINTMENT AND COMPENSATION OF TRUSTEES

The legislation also alters the process for the appointment of trustees who assume responsibility for the operation of the railroad, the preservation of the debtor's estate, and the protection of the creditors rights. The responsibilities require an extensive knowledge of transportation matters. Under current bankruptcy procedure, the appointments must be submitted to the ICC for ratification. The method provided by section 9–301 of H.R. 31 would omit this ratification and would give the ICC the same status as any interested party testifying at the hearing on the appointment. The report suggests that this change is made in the interests of eliminating another duplicative function and thereby expediting the process. However, ICC approval of trustees is not a time-consuming procedure—it is usually done in a matter of days. And, ICC ratification does carry with it the safeguard that the appointees' competence in transportation matters will be scrutinized by a body with a special expertise in the area. Reliance solely on the bond requirement of section 9–302 of H.R. 31 is not an adequate substitute. Again, the Bankruptcy Commission's recommendation is a reversion to pre-section 77 days when criticism of the quality of trustees led to the requirement of ICC approval.

The method for determining the compensation of trustees which is now set forth in section 77(c)(2) of the Bankruptcy Act, would also be changed by this bill. Under current law the ICC sets the maximum limits for compensation and the judge allows payments to be made to the trustees from within this range. Section 4–404 of H.R. 31 would authorize the court to set the compensation for trustees and other persons, with the ICC acting in an advisory role. We have no objection to this change. The courts should be generally able to rule on compensation applications, and the Commission could use its recommendation to provide assistance to the court on the value of transportation-related services.

TRANSPORTATION AND CONSOLIDATION OF CASES

One feature of Chapter IX which we believe has considerable merit is the liberal provision for transfer and consolidation of rail bankruptcy cases. Section 9–303 provides that such transfers shall be made by the judicial panel on multidistrict litigation upon initiation of a proceeding by any party in interest, the panel itself, the trustee, or the judge handling one of the cases. The consolidation may occur if there is a dispute between two or more debtors, one or more common questions of fact, or a possible merger or common plan of two or more debtors.

Under the present system, there has been considerable delay engendered by the failure to consolidate closely related proceedings. For example, while the New York, New Haven and Hartford Railroad was in reorganization in the 1960's, one of its lessors (Boston & Providence Railroad) was also in reorganization. The New Haven trustees were continually shuttling back and forth between the United States District Court for the District of Connecticut, which possessed jurisdiction over the reorganization of the New Haven, and the United States District Court for the District of Massachusetts, which had jurisdiction over the B&P reorganization. Moreover, each of these courts' orders were appealable in a separate Circuit Court. This split of jurisdiction undoubtedly caused delay and unnecessary efforts on the part of the parties involved.

Furthermore, there may be open conflict between courts having jurisdiction over related railroads. An example of this conflict is the dispute between the New Haven Court and the United States District Court for the Eastern District of Pennsylvania. The latter had jurisdiction over the reorganization of the Penn Central Transportation Company, which then owned and operated the former New Haven lines. See *New Haven Inclusion Cases*, 399 U.S. 392 (1970). The New Haven Court entered an "equitable lien" and a "constructive trust" on the former New Haven properties to protect the New Haven interests. The Pennsylvania Court responded by enjoining the New Haven trustees and their counsel from seeking to enforce such lien or trust. The New Haven Court thereupon appointed special counsel apparently to record the lien in each of the States in which the former New Haven properties were found. The New Haven Court's action was reversed by the United States Court of Appeals for the Second Circuit on the ground that the district court lacked subject

matter jurisdiction under section 77(a), since the property affected was within the exclusive jurisdiction of the Penn Central Court.

Certainly, no purpose is served by this kind of dispute, and section 9–303 seems precisely designed to avoid such situations. We believe that emphasis on early consolidation, which would be encouraged by this section, could produce substantial reductions in delay and unnecessary litigation. It could also lead to more comprehensive consideration of the broad transportation issues involved in multiple rail reorganizations.

H.R. 32

The second bill before your Subcommittee, H.R. 32, is the recommendation of the National Conference of Bankruptcy Judges, and the provisions of section X of that bill revise the procedures to be followed in rail reorganizations. Essentially, this bill takes the same approach to rail bankruptcies as does H.R. 31, and transfers many of the administrative functions involved from the ICC to the courts. Thus, our comments of H.R. 31 are largely applicable to H.R. 32. There are, however, some differences between the two versions which should be noted.

First, while H.R. 31 would leave jurisdiction over rail reorganizations in the district courts, H.R. 32 would place jurisdiction in the bankruptcy courts, which are created pursuant to Chapter II of that bill. We believe that the problems created by over-judicialization of rail reorganizations are essentially the same whether their jurisdiction is in the district courts or in a more specialized tribunal. The disadvantages we foresee in enactment of H.R. 31, with respect to increased involvement of the judiciary, are equally inherent in H.R. 32.

Another difference between the two bills is the absence in H.R. 32 of the provisions found in section 9–303 of H.R. 31 which permit the transfer and consolidation of rail bankruptcy proceedings. As previously indicated, we believe that these provisions are beneficial and should be included in some form.

Further, section 10–104(b) of H.R. 32 would preserve the right of the Interstate Commerce Commission to appeal decisions of the bankruptcy court. The Bankruptcy Commission's proposal, on the other hand, provides in section 9–105(b) that the ICC may not appeal from any judgment entered in a bankruptcy case. The approach of H.R. 32 is obviously preferable, particularly in view of the diminished role assigned to the ICC in the earlier stages of the process. The Bankruptcy Commission's proposal would relegate the ICC to an advisory position, provide that its advice could be ignored, and preclude it from taking an appeal from a decision made by the court. This effectively removes from the rail reorganization process the benefits of ICC expertise in the areas of rail financing and operation and does not assure that there will be adequate consideration of the public interest. The approach of H.R. 32 is preferable in that it at least allows the ICC to appeal from judgments of the court and present its views to the reviewing court.

ALTERNATIVE PROPOSALS

Although we do not support the general direction of H.R. 31 and H.R. 32, we do agree that changes should be made in section 77. The purpose of these changes should be to provide a more efficient process and one that leads to a reorganized railroad that provides optimal service to the public while meeting the rights of creditors and stockholders.

To accomplish this result, it is important to eliminate some of the duplication of functions between the courts and the ICC. But we propose accomplishing this by giving the ICC the primary role in transportation and procedural aspects of rail reorganizations while giving the courts essentially a review function. Our reason for this approach are two-fold. First, a great deal has been heard recently about how overburdened our court system is. In view of the clogged court dockets, it is likely that the assignment of more responsibility in complex rail reorganization cases to the courts will produce even greater delays in the processing of these cases. The Commission, too, is busy; however, the nature of rail reorganizations is such that they can be integrated rather well with the Commission's other rail regulatory functions. Also, pursuant to section 309 of Public Law 94–210, the Rail Service Planning Office has been established as a permanent office within the Commission. This Office, which originally served to evaluate the rail plans developed under the Regional Rail Reorganization Act of 1973, has a general mandate to conduct an ongoing

analysis of national rail transportation needs and to evaluate programs to meet those needs. It would be available to the Commission to assist in carrying out any new functions having to do with future rail reorganizations.

Second, rail reorganization cases involve primarily transportation issues; that is, determinations of what level of rail service is really essential and how much and what type of service can be retained consistent with the private rights of stockholders and creditors. These are decisions that the Commission is best qualified to make since they involve many of the same factors that are part of the Commission's day-to-day adjudications in rail abandonment, merger, and rate cases.

Specifically, we propose that the process for the submission and approval of the reorganization plan be substantially revised. First, something must be done to eliminate the long periods of time during which all the parties sit back and wait for someone else to come up with a plan while neither court nor Commission can compel action. We suggest requiring the trustee, rather than the debtor, to file a plan of reorganization within six months of approval of the petition. This would solve the problem of having the debtor, which is invariably oriented to the equity interests, having the least rank, delay development of a plan or come up with a totally unrealistic plan from the standpoint of the public and the creditors.[2]

There should still be an opportunity for extensions, but the statute should make it clear that such extensions will be granted only for good cause specifically shown. Moreover, the Commission should have the responsibility for granting the extension since the Commission, with its greater familiarity with the subject matter, is best able to determine whether the complexity of the issues involved warrant extensions.

Furthermore, in order to ensure that the plan is developed in a business-like manner, the Commission should be given the jurisdiction to direct the trustees to take, within periods of time set by the Commission, certain actions such as analyses leading to a determination of which properties are essential to the production of vital services, which services are likely to run on a break-even or better basis, which services are likely to produce a deficit, and which services and facilities could or should be eliminated; and of how the debt should be restructured to a kind and amount capable of being services under the railroad's revised physical configuration giving due regard to the rights of creditors, the public need, and the prospects for achieving a reorganization plan. This authority would enable the Commission to ensure the expeditious development of a plan and would put before the court, the Commission, and the parties information needed to judge the validity of a plan.

The next step is to eliminate the duplicative review functions that are so instrumental in delaying the process. At present, there must be a Commission hearing and decision followed by a court hearing and decision, after which comes referral back to the Commission for submission to the creditors and stockholders for their vote on the plan, which vote is followed by certification of the vote back to the court which then confirms the plan. This process is further delayed by the fact that both the court's approval and confirmation are appealable and can be even further drawn out if the court does not approve the plan but refers it back to the Commission. We believe that this process can be greatly streamlined by having the Commission decide on the final plan and the court review that decision, rather than rendering its own *de novo* decision, and by ensuring that the creditors' and stockholders' views are considered on the record before the Commission, rather than requiring separate submission of the plan to them after court approval.

We propose that after the submission of the required plan by the trustees, all interested parties, including the Department of Transportaion, be allowed a limited statutory period of time to submit alternate plans or to comment on the trustee's plan. Then the Commission should conduct extensive conferences between the parties, analogous to informal conferences held pursuant to the promulgation of proposed rules under the APA. After these conferences, the Commission would be required to promulgate a proposed plan, which then would be the subject of a formal hearing and a final decision by the Commission.

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[2] We note that section 7–304 of H.R. 31 does place the primary requirement for development of a plan on the trustee and we support this change from section 77(d), which places this requirement on the debtor.

This procedures would have several advantages. The Commission and the parties would have available to them the underlying factual information and the basic position of the parties involved. The informal conference and discussion period would allow for the resolution or minimization of differences before inflexible positions are drawn in formal hearings. It would also allow the Department of Transportation, which has certain new authority under Public Law 94–210 to distribute rail rehabilitation funds and to conduct national rail planning, to present its views and proposals as to how the reorganization should be accomplished to best fit into a national rail system. The information-gathering and conference approach is patterned after section 401 of Public Law 94–210 which authorizes the Secretary of Transportation to perform similar functions for the purpose of making merger proposals to the ICC. Just like a reorganization plan under section 77, these proposals are intended to produce a more efficient system. By utilizing similar techniques in reorganization cases, it appears to us that an acceptable reorganization plan can be more efficiently and expeditiously developed.

Once the proposed plan is issued, the Commission would hold a hearing on it after which the Commission's decision would be issued. We note that the Bankruptcy Commission indicates concern about delays at the Commission, and we have already shown that with regard to development and approval of the plan, it is certainly not the Commission which is primarily responsible for such delays. Moreover, Public Law 94-210 includes provisions designed to expedite decisions in cases such as these. Section 303 contains deadlines for Commission decisions and eliminates unnecessary levels of appeal with the Commission. Moreover, that section specifically provides that in important rail cases, the Commission may dispense with the usual initial decision by an Administrative Law Judge or other official and consider the case itself in the first instance. Consideration of reorganization plans would be likely candidates for this expedited procedure, particularly if extensive informal procedures have taken place. Also, the Commission will have RSPO personnel at its disposal to aid in the expeditious development of a plan. The sum of all this is that the Commission is the most likely candidate to produce a workable plan quickly and efficiently.

Once the Commission has rendered its decision on the plan, we believe that the court should perform essentially a reviewing function, rather than the present practice of conducting a de novo hearing and rendering an entirely separate decision. The substantive standards for the court's decision as set forth in the present section 77(e) are whether the plan meets the appropriate legal standards and is fair and equitable. This is quite similar to the standard applied by courts reviewing other Commission decisions, and thus we believe that the court should be required to process these cases on an appeal basis rather than as de novo hearings with all of the attendant delays. We see no reason why judicial review of the Commission's decision on a reorganization plan should be any more lengthy or complex than review of a Commission decision with regard to a rail merger case.

After the court has approved the Commission decision, there should not be the further delay caused by referral of the case back to the Commission for the votes of stockholders and creditors and then transmittal back to the court for confirmation of the plan. The stockholders and creditors will have had full opportunity to air their views in the proceedings both before the Commission and the court. Since under the present procedure, the court may confirm the plan upon a determination that it provides fair and equitable treatment and that its rejection is not reasonably justified even if more than one-third of the creditors or stockholders disapprove, the formal vote has little effect beyond the presentation of views that the creditors and stockholders have already made. Plainly, the court must retain the authority to require implementation of the plan if it is fair and equitable whether or not it is favored by most creditors. But separate submission of the plan for formal vote by the creditors and stockholders takes up unnecessary time and should be eliminated. What is needed is a procedure, such as we have proposed, that ensures the full airing and consideration of the stockholders' and creditors' views during the formulation of the plan.

Another important change relating to the development of the plan that we recommend is the addition of a provision authorizing Commission approval of a plan which includes merger of two debtors or a debtor with another railroad, or the joint use of rail properties, without the express approval of the

debtor. Present section 77(b) states that such a merger can be part of the plan but pursuant to the Supreme Court decision in *St. Joe Paper Co.* v. *Atlantic Coast Line Railroad Co.*, 347 U.S. 298 (1954), the merger must be approved by "those who in the absence of section 77 would wield the corporate merger powers." By this, the court clearly meant the shareholders of the debtor.

We do not believe that any single person or interest should have veto power over a reorganization proposal. It is conceivable that a debtor's position might be such that its stockholders would have no opportunity, no matter what kind of reorganization of liquidation plan was ultimately carried out, to receive any compensation for their holdings. In such a case they should not be permitted to block a plan otherwise in the interests of the public and the secured creditors. We believe that the statute should permit adoption of a reorganization plan which includes a provision for merging the debtor railroad with a willing merger partner, or which involves the joint use of rail property, even in the face of opposition by the debtor or its creditors, provided that appropriate findings are made to the effect that whatever legal or Constitutional rights such parties may possess have been properly considered and protected.

Increasingly, mergers and consolidations are being viewed as vital to the maintenance of a viable nationwide railroad system. The entire process carried out under the Regional Rail Reorganization Act of 1973 involves the consolidation of six bankrupt railroads in the Northeast into one regional railroad, the Consolidated Rail Corporation. The Railroad Revitalization and Regulatory Reform Act of 1976, Public Law 94–210, contains an entire title (Title IV) which is intended to facilitate merger planning at the ICC and the Department of Transportation and to expedite Commission consideration of rail merger applications. Moreover, section 309 of that Act assigns the Commission's Rail Services Planning Office the specific function of assisting the Commission in studying and evaluating mergers and related proposals. Because of the growing importance of mergers as a means of rationalizing our rail system, it is essential that parties be authorized to propose mergers as the basis for a reorganization plan and for the Commission to approve such a merger as part of a plan without the consent of the debtor, if such merger is clearly in the public interest.

Turning to the subject of abandonments by rail carriers in reorganization, we believe that the way to eliminate duplication in decision making in this area is to have the court review the Commission's abandonment decisions in the same way that it reviews Commission decisions involving abandonment of lines by railroads not in reorganization. This should speed up the process since, rather than having to make an independent judgment on a line abandonment, the court would only have to review the record before the Commission to determine whether "substantial evidence" existed to support the Commission's decision. This approach is clearly the most appropriate since essentially the same balancing of public and private interest are involved in an abandonment whether or not the railroad is in reorganization.

Abandonments are important to the reorganization process since it is likely that in any successful reorganization, there will have to be some pruning of light density lines and redundant facilities. Here again, Public Law 94–210 should be of considerable assistance to the Commission in ascertaining what lines of a railroad in reorganization are likely candidates for abandonments. Section 802 of that Act adds a new section 1a to the Interstate Commerce Act, which requires each railroad to submit, and keep updated, a diagram of its entire transportation system including a detailed description of each line which is "potentially subject to abandonment" and an identification of any line as to which such carrier plans to submit an application for a certificate of abandonment or discontinuance. This information should be very helpful to the Commission in determining whether to grand abandonments and also should be of assistance in the development of a reorganization plan in that it gives the Commission a good perspective on the relative viability of the various parts of a railroad in reorganization.

Another important point to bear in mind about section 802 is that, in conjunction with section 303 of P.L. 94–210, it imposes time deadlines on all phases of the abandonment process before the Commission. These deadlines ensure that the Commission will process abandonment cases expeditiously, while at the same time, allowing adequate time for public hearing on the vital issue of whether the public interest lies with continued rail service or abandonment. These deadlines should be sufficient guarantee that abandonments will be

handled expeditiously by the Commission, and as we have previously indicated, we believe that the Commission should exercise the primary decision-making authority in these cases. But if the approach taken in section 9–403 is to be followed, we strongly recommend that the sentence beginning in line 14 on page 257 of H.R. 31 be modified to provide that any time limitation imposed on the Commission be no less than the time imposed on the Commission under sections 303 and 802 of Public Law 94–210. These time periods provide the minimum time necessary for the Commission to conduct a hearing into the needs of the users of the rail services involved, and at the very least, the Commission's expertise should be used to ascertain the needs of the users of rail services and how those needs can be met. This is precisely one of the functions that the Commission and its Rail Services Planning Office performed under the Regional Rail Reorganization Act of 1973, and it should continue to perform that function with regard to railroads in reorganizations. If a further hearing in court is deemed necessary—a process which we oppose—it should be limited to non-transportation matters over which courts normall have primary jurisdiction.

These are the main proposals we have for changing section 77 to produce a more efficient reorganization process. Our approach has been to eliminate duplications by giving the Commission the decision-making authority with regard to transportation matters (with normal court review) and leaving with the court the authority to decide primarily legal issues. We have also tried to take into account the landmark rail legislation embodied in P.L. 94–210. We strongly recommend that the Subcommittee take a similar approach in any legislation that it ultimately reports. To this end, we would be happy to put into bill form the recommendations we have made in this statement, if the Subcommittee so desires.

This statement represents the views of the Commission except that Commissioner Corber does not join in the Commission's recommendations in the section entitled "Alternative Proposals" to the extent that they go beyond comments on H.R. 31 and H.R. 32, and Commissioner MacFarland was absent and did not participate.

This concludes my prepared remarks. We will be pleased to answer any questions that the Subcommittee might have.

[Memorandum]

May 31, 1976.

To: Thomas L. Burgum and Robert E. Fiedler, c/o Subcommittee On Improvements In Judicial Machinery, U.S. Senate Judiciary Committee, Senate Office Building, Washington, D.C.

From: Raeder Larson, National Building, Minneapolis, Minn.

Subject: Pending Bankruptcy Legislation and Chapter VI—Regular Income Plans.

Regarding the pending bankruptcy legislation, thank you for permitting me to review and comment upon your Draft # 1 of Chapter VI. Providing maximum statutory opportunity for successful Chapter VI (now Chapter XIII) wage earner-consumer payment plan cases as an alternative to straight bankruptcy is the preeminent objective for almost everyone involved in the consumer bankruptcy debate. As you know, my personal employment for fifteen years has been counseling and representing such debtors who strive to pay debts out of current income under bankruptcy court protection and supervision, really legal clinic work rather than normal law practice. In addition, local circumstances have ordained my participation in local court and trustee planning and operations. This commentary is made therefore from a background of legal experience, counseling and court-trustee involvement. My assumption is the "Director" will be the director of a court services administrative office for a Bankruptcy Court System with a judicial conference of bankruptcy judges and trustees accountable to both the court and the director, and that Part II of S.235 will be revised and replaced accordingly. References to pending bills are limited to S.235 for brevity and convenience. Finally, this commentary is not intended to be complete but only selective and as brief as possible.

Several sections need summary comment first. Section 6–309 is new, stays any setoff but preserves a de facto lien, and is satisfactory. Active checking accounts are troublesome, but 6–309(c) provides a remedy where debtor de-

posits income after filing his petition and the bank then applies setoff or withholds payment of checks issued. Part of section 6–402(b)(1) and all of 6–701 have been deleted, thereby creditors are not charged with case costs, and I concur. Section 6–403 regarding codebtors has been revised and limited and cannot be improved. The stay provided is essential and the terms for modifying the stay, where the codebtor is reasonably able financially to pay such debt, are appropriate. Finally, section 6–101(c)(6) requires the Chapter VI Trustee to continue in liquidation, which however is usually inappropriate. The functions are different and specialized. Generally there should be both payment plan standing trustees and also standing trustees for consumer bankruptcy liquidation cases, to perform the separate functions, at least in metropolitan areas. The Chapter XVI Trustee should continue in liquidation only until and unless a successor trustee is duly appointed or elected. Detailed comments and suggested revisions for section 6–101 and section 206(b)(f) of Part II of S.235, regarding the trustee, counseling and attorneys, are made at pages 11–17 of this letter.

Section 6–301 refers to plan provisions. The administrative office and each court territory need authority to establish considerable uniformity in plan provisions for economy in operations. No trustee office or centralized accounting office could make distributions economically with each plan providing a different distribution system. Unsecured creditors can be paid monthly, quarterly, by 10% dividends or whatever, and each secured creditor can be paid its stipulated separate amount monthly or whatever, but the system for all plans should be the same. Let the administrative office devise the best system, which may even differ from area to area. The first paragraph of 6–301 should be revised to state:

"Sec. 6–301. Provision of Plan. Reasonable uniformity of plans and provisions thereof shall be as prescribed by the Rules of Bankruptcy Procedure or by local bankruptcy rules. A plan under this chapter * * * ."

This revision would also permit restriction of composition to several basic plans, payment of either ⅓, ½ or ⅔ to the unsecured creditors as an example (30%, 50% or 70% is another alternative), if appropriate.

Section 6–301(1) requires all unsecured debts be treated equally. Large unsecured debts are a real problem, since smaller debts are long delayed in payment when large debts must be treated equally. We try to extend such claims by agreement despite 11 U.S.C. 1046. Plans which extend the term of or apply composition to large unsecured debts compared to other unsecured claims should be permitted. The sole cut-off could be $1000. Unsecured home improvement loans, large medical debts, deficiency balance claims and educational loans are typical examples and often exceed $1000 in amount due. Section 6–301(1) should be revised to state:

"(1) shall include provisions dealing with unsecured claims generally, on any terms, or dealing with unsecured claims divided into two classes, those $1000 or less and those exceeding $1000, each class with separately on any terms generally, provided however the terms dealing with claims of $1000 or less shall be no more onerous than the terms dealing with unsecured claims exceeding $1000, and may alter or modify the rights of the holders of such claims;"

A 50% composition of unsecured debts over $1000 could be proposed, others paid in full. More likely, a plan could provide 5% dividends to unsecured debts over $1000 when others were paid 10%, until those under $1000 were fully paid. This limited two-class provision permits some flexibility, yet remains as uncomplicated as possible. More than two classes however would be unwise and unworkable.

Section 6–301(2) permits curing of defaults and maintenance of payments on claims secured by a lien on the debtor's residence, which is fine for home improvement and most second mortgage liens (consumer debts) but hazardous for original financing (personal housing expense), since among other hazards debtor renters and their landlords are not given similar preferential opportunities. The flexibility would be preserved while limiting the term by changing section 6–301(2) wording to:

"(2) May include provisions * * * and may provide for the curing of defaults within a reasonable time on claims secured by a lien on the debtor's residence, and may provide for the maintenance of payments while the case is pending on claims for nonpurchase-money debts secured by a lien on the debtor's residence; provided, however, * * * under this chapter;"

Such wording would exclude maintenance of payments except to cure default on original financing, typically a first moregage or land contract or both.

Section 6–401 regarding filing of claims generally makes section 4–401(b)(5) of S.235 applicable by silence, which allows late prepetition claim filing only after all other claims are fully paid. No useful purpose except convenience and arbitrariness is served by this unfair and unnecessary restriction. Late claim filing is a modern commercial necessity when coping with tides of papers and undelivered mail, whether private firm or public tax department. In liquidation cases the rule is proper, but in payment plan cases, if postpetition claims are permitted under 6–401(b), then late prepetition claims should be permitted also. The present rules (Rule 13–303) and section 4–401(d) of S.235, which permit the trustee to file claims after the first meeting, have become exercises in excess paper and labor, since many trustees are now filing claims for all scheduled creditors soon after the first meeting and then the court and trustee must cope with frequent amendments. In Minnesota we simply allow late claims by waiving the claim filing period. Usually the debtor wants all debts paid, except as he may file objections to allowance. Handling late prepetition claims is no more difficult for court and trustee than postpetition claims. Time and effort for all concerned will be saved and the cause of justice served by revising section 6–401(b) to read:

"(b) Filing of late prepetition claims and post petition claims. The time for filing late prepetition claims and postpetition claims of the following * * * by the Rules of Bankruptcy Procedure:"

and inserting a new paragraph (4) following paragraph (3) in section 6–401(b) stating:

"(4) Uncontested claims against the debtor existing on the date of the petition held by creditors bound by a confirmed plan under section 6–306(d) where the debtor or trustee file the claim pursuant to section 4–401(d), where the debtor duly consents to the late filing of such claim or where failure to file the claim within three months after the first date set for the first meeting of crediors resulted from lack of notice of excusable neglect."

Section 6–304 specifically requires that secured claims be filed before the first meeting of creditors, but general business practice would suggest all claims have the same time limit. In addition, penalties should be avoided which serve little purpose, and confirmation should be the goal, not arbitrary denial of distribution. Plan provisions regarding secured creditors need standardization (discussed above) and security could be evaluated by court order or otherwise both after and at the first meeting. Be flexible and permit the administrative office to devise the best system, which may even differ from area to area. The last sentence of 6–304 should be changed to read:

"Sec. 6–304. Time for Filing Secured Claim. A claim secured * * *. Any claim not filed by the creditor within such time limit shall not be treated as a secured claim for purposes of [*distribution in the case*] confirmation of the plan by the court pursuant to section 6–306."

This revision achieves the desired goal without imposing unnecessary penalties or unreasonable requirements upon secured creditors.

In connection therewith, section 6–307(a) relating to plan modification also needs revision. It is impractical and uneconomical to expect all secured creditor matters to be settled by the first meeting in every case and adjournments merely to settle such matters are not really necessary but rather personal preference by the judge involved. The need for plan standardization requires later flexibility, which is not met by 6–305 for preconfirmation modifications. So long as the "full value" of 6–306(a) and due process of 6–305 are preserved, permitting postconfirmation modifications would recognize the realities of modern commercial practices. The last clause of the first sentence of 6–307(a) should be revised to state:

"(a) Modification of Plan After Confirmation. At any time * * * or may, by following the procedure prescribed in sections 6–305 and 6–306 for modification and confirmation, convert an extension plan to a composition or may modify the plan and confirmation order to alter the terms of dealing with any claim secured by property or otherwise alter or modify the rights of the holder of such claim to rectify mistakes, omissions or inadvertence. Such action shall only be taken if consistent with section *–306(a)."

This revision would permit the court to deal fairly and effectively with any secured claim without dependence upon plan perfection or the constraint of first meeting deadlines. The interrupted underlining denotes your previous revision. The reference to 6–305 due process modification procedure is added to 6–307(a) since 6–306(a) deals with court findings and is silent on procedure

except for hearing objections, while 6–307(b)(2) correctly refers to both 6–305 and 6–306.

Section 6–306(a), the confirmation section, is still defective (as is 11 U.S.C. 1056) by failing to provide any guidance for confirmation beyond feasible, full value, good faith and best interests. The old "fair and equitable" rule necessarily deleted in 1952 was never replaced. Courts, lawyers and authorities have continued to struggle with payments and secured creditors. Full value, no voting, late claim filing and postconfirmation modification, assuming the above revisions to 6–307(a) and 6–401(b) are made, basically solve secured creditor problems, but the payments problem remains unsolved. Three years has been the informal standard, but some plans are appropriate for four years or longer and others are inappropriate for two years. The courts and administrative office will eventually have to establish guidelines, but meanwhile the statute should provide some standard to permit development of guidelines based on experience. With present creditor voting the courts have tended to avoid this problem, but without creditor voting on plans, the courts will have an obligation to consider basic fairness whether the statute says so or not. It is better to provide some clue to a fairness standard than remain silent, and section 306(a) should be revised to read:

"(a) Confirmation. After hearing * * * that the plan has been proposed in good faith and that the payments proposed by the debtor under the plan are reasonable for his circumstances * * * and is feasible."

This "reasonableness for his circumstances" revision would provide courts some guidance in considering confirmation of plans without creditor voting. My general belief is that 20-25% of net family income paid for three years, or 60–75% of annual net family income paid over a three to five year period, for the usual four-member family, is basically a reasonable total payment for all creditors, excluding real estate creditor payments, if any, but the variations are numerous and defy definition, involving not only income and necessary family expenses but also the kind and cost of property the debtor has chosen to purchase. This section does permit confirmation of extension plans without affirmative voting creditors, and I strongly concur, but I have grave doubts about similar handling for compositions.

"With respect to compositions, sections 6–501 regarding discharge and 6–307(a) regarding modification need further revision, and pages 7-11 of this letter deal generally with composition plan voting, discharge and confirmation. Certainly composition is often appropriate, but it is not full payment. Full payment extension plans are disparaged and discouraged by the failure to distinguish extensions from compositions at either discharge or confirmation. In simple fairness, 6–307(a) should include court authority to convert a composition plan to an extension. Converting an extension plan to composition and the 6–501(a)(2) hardship discharge are reasonable provisions. The reverse is equally reasonable where debtor's circumstances improve dramatically and extension or less composition becomes feasible. Further, if the court has power to confirm a composition plan without creditor acceptance and a composition discharge will not bar a later liquidation discharge, fairness should require the court to then reconsider that decision upon completion of payments. Essentially the court should make the final decision on composition plans upon completion rather than at confirmation. The following revisions to 6–307(a) and 6–501 would accomplish that purpose.

The last clause of the first sentence of 6–307(a) should be further revised to state:

"(a) Modification of Plan After Confirmation. At any time * * * or may, by following the procedure prescribed in sections 6–305 and 6–306 for modification and confirmation, convert an extension plan to a composition or a composition plan to an extension or may modify the plan."

The interrupted underlining denotes the revision already suggested above at pages 5–6 for 6–307(a) regarding secured creditors and 6–305 due process modification procedure.

In addition, section 6–501(a)(1) should also be revised to state:

"(1) Where the debtor has completed performance of extension plan. On completion by the debtor of all payments under the plan by way of extension only, the court shall forthwith grant the debtor a discharge."

Further, the heading of 6–501(a)(2) should be revised to state "(2) Where the debtor has completed performance of composition plan or has not completed performance of plan.", subparagraphs (A) (B) & (C) of 6–501(a)(2)

should be relettered (B) (C) & (D) respectively, the heading of relettered (B) should read "(B) Performance not completed application and notice.", and a new subparagraph (A) should be inserted therein stating:

"(A) Completed performance of composition plan application and notice. A debtor who has completed his payments under a plan by way of composition shall be deemed to have made application to request a discharge on the ground that his composition plan has been performed and that modification of the plan pursuant to section 6-307(a) is not feasible, and the clerk shall give notice to all creditors as provided in section 4-309(b)(1) of the time fixed for filing complaints objecting to discharge."

Finally, 6-501(b) should be revised to state:

"(b) Effect of discharge. A discharge granted pursuant to paragraph (1) or subparagraph (A) of paragraph (2) of subsection (a) of this section extinguishes all liability of the debtor on claims provided for by the plan, and a discharge granted pursuant to subparagraph (B) of paragraph (2) of subsection (a) of this section extinguishes all liability of the debtor on unsecured claims provided for by the plan, except * * * discharge."

Creditors do not object to confirmation of any reasonable good faith extension plan without creditor voting but strongly object to composition plans without creditor vote on acceptance or rejection of the plan. Providing court review after notice to creditors before discharge of composition plans would reduce such objections. In the absence of the above revisions for 6-307(a) permitting conversion of a confirmed composition plan to an extension and 6-501 providing court review before discharge, a creditor vote should be provided on composition plans by the following revisions for section 6-302(a), 6-303 and 6-306(a), which should be revised to read:

Sec. 6-302. Filing of Plan

(a) Time for filing plan: Identification of plans. The debtor may file a plan * * *. Each plan filed and any plans for which acceptance of creditors entitled to priority or secured by personal property or unsecured with respect to plans by way of composition are solicited must be appropriately identified.

Sec. 6-303. Combined Notice * * * Proof of Claim Form. A combined notice * * * and a proof of claim containing provision for acceptance or rejection of the plan by creditors entitled to priority or with claims secured by personal property or with unsecured claims with respect to plans by way of composition.

Sec. 6-306. Confirmation of Plan.

(a) *Confirmation.*—After hearing any objection * * * the court shall confirm a plan if * * * and is feasible, and with respect to a plan by way of composition if it has been accepted in writing by a majority in number and amount of the unsecured creditors of each class affected by the plan whose claims have been filed and allowed before the conclusion of the first meeting of creditors. A creditor who files an unsecured claim but who fails to file a rejection of the plan before the conclusion of the first meeting of creditors shall be deemed to have accepted the plan.

In conclusion, with respect to composition plans, discharge and confirmation, many participants in the consumer bankruptcy debate, not limited to those representative of creditor interests, feel strongly that creditors should be able to vote on the acceptance or rejection of any plan by way of composition as elemental justice, particularly in light of the simplified procedure and increased availability of the hardship discharge for uncompleted plans under 6-501. The above revisions for 6-302(a), 6-303 and 6-306(a) would accomplish such voting and make the immediately next above revisions for 6-307(a) and 6-501 unnecessary. The latter revisions are necessary if creditor voting on composition plans is not so provided. My personal preference is for the stated 6-307(a) and 6-501 revisions without creditor voting, but many members of bar association bankruptcy committees strongly prefer creditor voting in compositions without a court hearing before granting a composition dischage. In my opinion either system would be fair, workable and appropriate.

Section 6-501 does help to solve a problem regarding the current high rate of dismissals in wage earner plan cases. More than half of present Chapter XIII dismissed cases would be considered successful cases in Chapter XI, since substantial dividends were paid creditors before the dismissal, yet an 11 U.S.C. 1061 discharge (de facto composition) or original composition plan is usually not appropriate under present law since it would bar a subsequent discharge within six years after the proceeding was commenced. Section 6-501

(a)(2) combined with 4–505(a)(7) of S.235 essentially solves this dismissal problem by providing an adequate system for hardship discharge without the burden of a bankruptcy discharge. Original composition plans would remain adequately covered under the revisions suggested above, combined with 4–505 (a)(7), again without the burden of a bankruptcy discharge. However, notwithstanding the authorities, section 4–505(a)(7) of S.235 is not perfectly clear, and the words "under Chapter IV" should be inserted so that it then states:

"(7) He was granted a discharge under Chapter IV or had a plan confirmed under Chapter VII or VIII in a case commenced within five years * * *.

The remainder of this letter will deal generally with counseling, the trustee office and attorneys. More adequate counseling assistance to debtors trying to cope with both debts and continued living expense with limited wages is a fundamental need in Chapter XII or Chapter VI cases. Financial counseling alone is not enough. Section 6–101(c)(5) provides that the trustee shall "counsel and supervise the debtor in the performance of the plan", which is exactly right but silent about funding and other problems. Counseling is no panacea, and might prove unworkable or too expensive, but should be given a fair trial. The administrative office should be given authority to explore interim funding and temporary grants, both public and private, to permit and establish temporary counseling programs, without attempting to achieve either uniformity or complete service at this time. Considerable experimentation with administrative office supervision is needed before permanent programs for effective counseling services and funding thereof in Chapter VI Trustee Offices generally are feasible. Experience could then lead to permanent solutions, programs and funding. Section 206(b)(f)(6) of Part II of S.235 suggests the general purpose but the counseling should be delivered through the trustee office of course. I am uncertain about wording, but perhaps said 206(b)(f)(6) could be revised to state:

"(6) Seek and accept on behalf of and in cooperation with trustees appointed under section 6–101, public and private temporary funding and grants, to finance employment by such trustees under his supervision of qualified persons to provide for individuals with regular income who have petitioned for relief under Chapter VI counseling for the purpose of reducing the rate of defaults on plans by debtors who are paying their debts under supervision of the court, or to finance contracting for such services by such trustees under his supervision."

Theoretically, additional counseling expense would be covered by the usual charges. As a practical matter, both model and start-up funding is essential before regular counseling can be established and funded by the usual charges. Generally as much discretion should be given the administrative office and trustee offices in Chapter VI cases as possible. You indicated some authorities feel the new rules preempted areas of substantive law, which may be true in straight bankruptcy, but Chapter XIII is really an administrative social and financial service court proceeding, and I feel there have been few complaints about the Chapter XIII Rules. Most complaints involve failure of the debtor to make prompt and sufficient payments, resulting in failure of the trustee to pay dividends and ultimate dismissal, which could be cured by full employment and adequate wages and is beyond our power to correct. In the meantime, a cooperative counseling effort by trustee offices with administrative office supervision may help and should be tried.

Section 6–101(c) regarding general duties of the Chapter VI Trustee, combined with sections 4–307 and 4–308 of S.235, have troubled me, perhaps because others have indicated the trustee will "concentrate on performing legal service such as objecting to claims and obtaining orders necessary for carrying out plans" and "act as his own attorney in adversary proceedings and contested matters" (49 Am. Bankr. L.J. 32–33). My visualization of the Chapter VI Trustee Office does not exclude such legal service, which however are overstated, but instead would emphasize advising the court, supervising and counseling the debtor, adjusting or mediating claim questions, and receipt-disbursement functions, a "full-service office". Too much legalism can defeat the real Chapter VI purpose, which is to help the debtor pay debts, survive without fear and provide decently for self and family while doing so. Considerable flexibility is required to achieve this purpose and section 6–101(c) should be revised to add definition and emphasize flexibility and social purpose. Paragraph (6) should be corrected as stated at page 2, paragraph (5) divided,

other paragraphs grouped and revised, and new wording added. Section 6–101(c) should then read as follows:

(c) *Duties of Trustee.*—When required by the court or the Director the trustee shall perform the duties specified by section 4–307 and 4–308, and in addition shall:

(1) Make recommendations to the court as to the feasibility of the debtor's plan, counsel and supervise the debtor in the performance of the plan, and obtain orders necessary for carrying out the plan;

(2) Assist the court by presenting evidence relative to the value of security and make recommendations to the court concerning application of any party in interest to modify the plan and confirmation order or to alter the amount of distribution to any creditor with respect to any claim secured by property or dealt with by the plan;

(3) Receive payments under the plan by a debtor, act as disbursing agent and account for all receipts and disbursements pursuant to sections 4–307 and 4–308, unless the court by order directs otherwise;

(4) Temporarily modify or suspend a debtor's payments under the plan when circumstances so warrant or require and report such actions to the court, and make recommendations to the court concerning any application by a debtor for other than temporary suspension or modification of such payments or for leave to incur any new debt not approved by the trustee; and

(5) Where the debtor is in default, move for the dismissal or the conversion of the case to one for liquidation, and upon conversion of a case to one for liquidation, continue to serve as trustee and perform the duties of a trustee, until and unless a successor trustee is duly appointed or elected.

This revision of section 6–101(c) visualized a trustee office providing most supervisory, advisory and financial services to the court and the debtor. Centralized accounting and even disbursements can come when the administrative office, courts and trustees have become appropriately prepared. Section 206(b)(f)(4) of Title II and sections 2–106(a)(5), 3–103, 4–307 and 4–308 of S.235 relate to receipts and disbursements of funds deposited by debtors, but in Minnesota we prefer local receipts, deposit and disbursement and believe satisfactory computerized accounting systems are long-range goals rather than short-range certainties. Hence the emphasis of these provisions has been reversed, so that the trustee shall both receive and disburse the funds but that the court may designated the clerk to received and the director to deposit and disburse such funds, thus providing flexibility while retaining local handling where appropriate. The trustee remains accountable to both the director and the judge, and investment of funds pending distribution could be a prescribed by the rules and regulations to be adopted by the director (the practice in Minnesota by local rule for many years).

Further, this visualization includes the trustee office performing most of the additional so-called legal "professional services" contemplated by section 6–402(a)(2)(B), which could be handled without fanfare by a trustee office given discretion to temporarily modify payments, settle secured creditor problems and adjust creditor claim questions, securing court approvals or decisions only when completed or contested. Generally only one attorney fee should be paid, and every effort should be made to handle everything possible in the Chapter VI case after confirmation through the trustee office and to deliberately avoid involving the attorney with mere paper work for additional fees. You may wonder if I have a double standard for attorneys in this regard, one for Chapter VI and another for consumer liquidation cases. Actually different rather than double standards are involved, liquidation being continuously adversary but Chapter VI needs to be generally adversary only until confirmation of a plan, thereafter allowing the trustee office and the court enough flexibility to both supervise and assist the debtor complete the program.

Finally, appointment of Chapter VI standing trustees by the director is provided by section 6–101(a), but the general character of Chapter VI suggests the local bankruptcy judges will and should participate also. To make such process more apparent, an additional sentence should be added to 6–101(a) stating:

(a) Standing Trustee.—Whenever in his judugment * * * the panel of trustees provided for by section 4–301. Any appointment of a trustee by the director under this chapter, including a standing trustee, is subject to approval by the court."

Parenthetically, sections 4–301 and 4–302 of S. 235 do not provide for standing trustees in liquidation consumer bankruptcy and should. The ap-

pointment power controversy in consumer cases has generated more heat than light and whoever makes the appointment has more duty than power. Appointment of consumer bankruptcy trustees by the director subject to approval by the court from a panel qualified by the director may be the appropriate general solution, although there is nothing wrong with the judge appointing trustees from panels named by the director either. Good consumer bankruptcy and Chapter VI trustees are not easy to find and keep. The administrative office and judges will need to work together, to retain good experienced trustees, and to find and train capable new trustees.

My final comments involve attorneys generally in both consumer bankruptcy liquidation and payment plan cases. Section 4–203 of S.235 regarding preparation of schedules by agency employees and referral thereupon to attorneys for "counseling" and "disclosure", combined with other sections, proposed a system for administrative agency processing of consumer bankruptcy cases with only nominal personal legal representation, which in part prompted the promulgation of the Minnesota report and proposals. Section 4–203 of S.235 should be deleted as inappropriate, but to oppose 4–203 is not to say that consumer bankruptcy attorney services cannot be improved. All original factual information is confidential and may involve disclosures of privileged data by a debtor considering bankruptcy relief, but securing information, preparing schedules and providing all other necessary professional services in the case is not difficult in well-managed lawyer offices and can be done efficiently and economically. Special training and planning for lawyers are necessary however and the administrative office should be active in that regard. Paragraphs (5) and (8), also "and referral attorneys." in (7), in section 206(b)(f) of Part II of S.235 should be stricken, but two new paragraphs should be inserted stating:

"(5) Assist in providing specialized training to attorneys and their assistants upon request, in cooperation with appropriate professional associations, for rendering efficient and effective legal services to individuals with regular income filing petitions under this title, at charges to be proposed by the director, approved by the conference and paid by such attorneys.

(8) Establish guidelines for admission to practice before the court and for the allowance of reasonable fees by the court, for attorneys providing legal services to individuals with regular income filing petitions under this title, to be determined by the court, under rules and regulations to be proposed by the director after consultation with appropriate professional associations and approved by the conference."

As you have surmised before, I both strongly affirm the real value of lawyers in consumer bankruptcy but also strongly urge that steps be taken to guarantee that value. Paragraph (3) of the consumer bankruptcy proposals from the Minnesota State Bar Association, now ABA policy, contemplated action in this regard, specifically noted on page 5–6 of the Minnesota State Report dated December 26, 1975, and pages 5–6 of the Minnesota Special Report dated January 20, 1976, and lends support to provisions of this kind.

Thank you very kindly for this opportunity to present these thoughts to you and I hope the suggestions made will be helpful.

Respectfully submitted,

RAEDER LARSON.

VERMONT LAW SCHOOL,
South Royalton, Vt., July 6, 1976.

HON. ROMAN L. HRUSKA,
U.S. Senate,
Senate Office Building,
Washington, D.C.

DEAR SENATOR HRUSKA: Current proposals of the Commission on the Bankruptcy Law of the United States and the National Conference of Bankruuptcy Judges fail to adequately treat the question of whether the commencement of bankruptcy proceedings will defeat the right of a defrauded seller, under the Uniform Commercial Code, to reclaim property sold to the debtor. This problem, which was present in the American Beef Packers bankruptcy, has received broad attention recently by the federal courts. Under a recent line of decisions, the protection afforded sellers by the states in UCC §§ 2–702, 2–507 will not be enforceable if the buyer enters bankruptcy proceedings. This approach is undesirable since it permits the debtor's fraud to always inure to

the benefit of his other creditors or transferees while the seller is relegated to the position of an unsecured creditor.

The enclosed suggested amendment to the pending bills deals with the problem by providing that the right of the reclaiming seller is not to be defeated in bankruptcy proceedings on the theory that it constitutes a statutory lien or that it conflicts with the federal distribution priorities. The draft thus coordinates the proposed Bankruptcy Act with provisions of the Uniform Commercial Code and settles a disputed question. Importantly, under this proposal, the states retain the ability to determine the rights between reclaiming seller and other creditors or transferees of the debtor within the narrow range permitted by the qualifications contained in the draft.

A brief explanatory memorandum is attached to the proposed admendment; I would be most happy to respond to any questions generated by the proposal.

Very Sincerely,

JOHN C. MINAHAN, JR.,
Associate Professor.

Enclosure.

AMENDMENT TO PROPOSED BANKRUPTCY ACT

(Submitted by Professor Minahan, Vermont Law School)

Section 4–407. Right of Reclaiming Seller.—A seller's right under state law to recover property sold upon subsequent discovery that buyer received the property while insolvent or at a time when buyer had ceased to pay his debts in the ordinary course of business or had an inability to pay his debts as they became due shall not be defeated upon the commencement of a case under this act by or against the buyer as debtor because of anything contained in section 4–405 or 4–406 provided:

(1) Debtor received the property on credit or payment by draft which was subsequently dishonored; and

(2) Within 10 days of debtor's receipt of property seller made a written demand of debtor that property be returned; and

(3) At the time of debtor's receipt of the property seller had no actual knowledge of the contemplation of the filing of a petition under this Act by or against the debtor.

NOTE

(1) This section is new; in the circumstance stated it protects seller's right to reclaim property sold from avoidance on the ground that the state created right of reclamation is a statutory lien or that it conflicts with federal priorities on distribution. Decisional law is currently divided on the queston of whether the Uniform Commercial Code's reclamation provisions, UCC §§ 2–702, 2–507 are enforceable in bankruptcy. Compare *In re Good Deal Supermarkets, Inc.*, 384 F. Supp. 887 (D. N.J. 1974); *Matter of Federals, Inc.*, 402 F. Supp. 1357 (E.D. Mich. 1975); *In re Giltex, Inc.*, 17 UCC Reporting Service 887 (S.D.N.Y. 1975); *In re Wetson's Corp.*, 17 UCC Reporting Service 423 (Rev. S.D.N.Y. 1975) all of which refused to allow reclamation under the Uniform Commercial Code, with, *Matter of Telemart Enterprises, Inc.*, 524 F. 2d 761 (9th Cir. 1975) and *In re National Bellas Hess, Inc.*, 17 UCC Reporting Service 430 (Ref. S.D.N.Y. 1975) both of which allowed reclamation under the Uniform Commercial Code.

(2) The section is limited in application to a right of reclamation predicated upon discovery of buyer's financial difficulties. The Uniform Commercial Code definition of insolvency, UCC § 1–201(23), has been incorporated. The section leaves undisturbed existing law related to rescission on grounds other than discovery of insolvency.

(3) Subsection 1 makes clear that protection is afforded to the seller who accepts a draft which is subsequently dishonored. See UCC §§ 2–507, 2–511. The rights of a prepaying buyer under UCC §2–502 are beyond the scope of this section.

(4) Subsection 2 imposes a 10-day cut off and requires that the demand be in writing as conditions to the application of this section. UCC § 2–702's removal of the 10-day limit in the event of written misrepresentations of insolvency is not followed.

(5) Subsection 3. The same lack of knowledge requirement is imposed by a related section 4–506(a)(3).

(6) The sellers right of reclamation remains subject to the rights of third parties as defined in state law, see UCC 2-702(a), and thus may be subject to avoidance under section 4-604(b) of this Act. A pre-bankruptcy reclamation will generally not be avoidable as a preferential transfer, *Matter of Telemart Enterprises, Inc.*, 524 F. 2d 761, 764 (9th Cir. 1975), although the purported reclamation of property other than that sold could of course be treated as preferential under § 4-607. It would be contrary to the policy of this section to set aside pre-bankruptcy reclamation under § 4-607 on the sole ground that seller fails to demonstrate actual fraud. The presumption of fraud arising from the debtor's financial difficulties is sufficient.

VERMONT LAW SCHOOL,
South Royalton, Vt., November 8, 1976.

HARRY D. DIXON, JR.,
Minority Counsel, Subcommittee on Improvement in Judicial Machinery, U.S. Senate, Washington, D.C.

DEAR HARRY: Enclosed is a copy of the letter and memo that I mailed to Richard Levin—the memo was updated to include citation to the *In re Perskey & Wolf, Inc.* case. In all respects, the draft mailed to Richard is the same as § 4-407 in the Senate staff draft.

I read Professor Kennedy's remarks with interest. His construction of the section is entirely consistent with my intentions. You will recall that Professor Kennedy observed that, "It is not clear what the impact of your § 4-407 is on the right of recovery by a seller who relied on a materially false misrepresentation of the buyer's financial condition but who failed to make a written demand within ten days of the debtor's receipt of the property." I intentionally remained silent on that question as I was not prepared to state that such a right to reclaim is always invalid in bankruptcy. It seems to me that this decision should be left to the courts to decide in light of the particular circumstances of the cases. Here the courts have discretion, absent notification within the ten-day period, to declare that the particular reclaimation is a statutory lien or that it conflicts with the federal priorities. Section 4-407 merely gives a minimum of en day's worth of protection. Beyond the ten-day period, the courts could go either way.

With respect to the letter of Weintraub and Edelman dated October 20, 1976, and their comments (page 6) on § 4-407, I have some observations:

1. The omission of the UCC § 2-702 three-month extension was intentional. In essence, the § 4-407 position is a compromise between two competing policies: (1) The strong federal policy of providing fair and equitable treatment to all claimants and thus the policy against the recognition of "secret" interests (the seller has not filed or otherwise placed third parties on notice of the existance of his right to reclaim), and (2) the policy that a defrauded seller should be able to recover the goods. The issue becomes just how much protection should be afforded to the seller once bankruptcy proceedings are commenced. There is substantial support for a ten-day cut off: Firstly, that is the period provided in UCC § 2-702. Secondly, the current Bankruptcy Act gives force and affect to the UCC §§ 9-301 and 9-312 which allow purchase money security interests to be protected for a ten-day period without filing or possession. And lastly, current § 60(a)(7) of the Bankruptcy Act allows up to 21 days for certain interests to be "perfected." I therefore conclude that it is not repugnant to federal policy to allow the seller to have a "secret" right of reclaimation as long as it is of limited duration. On the other hand, a full three-month period in which to reclaim seems to give the defrauded sellers an unfair advantage—particularly under the UCC definition of insolvency which is incorporated in § 4-407.

2. Weintraub and Edelman erroneously conclude that § 4-407 deletes UCC § 2-702(3) limitations upon the seller's right to reclaim. They assume that the seller's right to reclaim is broader under the proposed §4-407 than it would be under state law (§ 2-702). This rational ignores the fact that § 4-407 looks to state law for the seller's right to reclaim—thus § 2-702(3) qualifications are already incorporated. Alternately stated, the proposed § 4-407 does not provide a substantive right to reclaim.

3. They propose a fourth subsection to § 4-407 on page 6 of their memo. The reference to UCC § 2-702(3) is unnecessary for the reasons stated in 2

above. I am sympathetic with their desire to allow the reclaiming seller to defeat a secured party who claims an interest in the goods under an after acquired property clause. However, a basic premise of § 4–407 is that the substantive right of reclaimation is to be defined by state law. It is the state legislatures which must determine the priority as between reclaiming sellers, secured parties, buyers in ordinary course, and whatever. Thus, in my view it would be inappropriate for Congress to provide that the reclaiming seller would defeat the secured party. If § 4–407 were amended to provide that the reclaiming seller would prevail as against the after acquired property clause, it would lead to a quite anomalous result. In bankruptcy, the seller could successfully reclaim the goods under Weintraub amendment to § 4–407, but, outside of bankruptcy, the secured party could prevent reclamation under UCC § 2–702(3). I would thus prefer to see this problem resolved under state law.

Another factor weighs against their proposal on the after acquired property claimant. H.R. 32 § 4–607(e) would have avoided such a secured party's interest as a preferential transfer. Although I favor such a rule, we are faced with the fact that the section has already been deleted from the Senate staff draft.

4. With respect to the discussion of UCC § 2–702(2) and reorganization proceedings, I do not feel qualified to comment in any detail. Whether the seller's rights are protected through a reclamation or through an administrative priority is a matter of form. The critical factor to me is that a seller who has knowledge of the debtor's insolvency or financial difficulties, or who has knowledge of the contemplation of the filing of a petition in bankruptcy, should not be given protection. The seller could retain a security interest in the goods, insist upon a cash sale, or decline to enter into a transaction with the debtor. It seems fair to say that such a seller deals with the debtor at his own peril. I cannot see a justification for granting such a seller more protection in a reorganization proceeding that he would have in a liquidating bankruptcy under the proposed § 4–407.

I enjoyed talking to you Sunday evening and will keep you posted on any developments.

Sincerely,

JOHN C. MINAHAN,
Associate Professor.

Enclosure.

LEVIN & WEINTRAUB,
COUNSELORS AT LAW,
New York, N.Y., October 20, 1976.

Re Hearings on S. 235 and S. 236 and H.R. 31 and H.R. 32.

THOMAS L. BURGUM,
U.S. Senate, Committee on the Judiciary, Subcommittee on Improvements in Judicial Machinery, Washington, D.C.

ALAN A. PARKER,
House of Representatives, Committee on the Judiciary, Subcommittee on Civil and Constitutional Rights, Washington, D.C.

DEAR MESSRS. BURGUM AND PARKER: Before delving into suggestions on amendments to the above bills, may I extend my thanks and commendations to all of you for your panel presentation at the Bankruptcy Judges Conference and the A.B.A. Business Committee. Several matters concern us with reference to the present posture of the bills and we are desirous of conveying our personal views to you.

I

In reading both the House Report and the N.B.C. Appendix and the Senate Staff Report we noticed the two different versions of a new section 4–407 dealing with a creditor's right to reclaim goods based upon an insolvent's misrepresentation of his financial condition. The N.B.C. version contained in the Appendix of the House Report recommends a return to a rule of fraud derived from the common law, while the Senate version incorporates § 2–702(2) of the Uniform Commercial Code as a basis for recovery.

You are undoubtedly familiar with cases which brought about the proposed legislation. Thus, *In the Matter of Telemart Enterprises, Inc.*, 524 F.2d 761 (9th C.ir. 1975) cert. den. —U.S.—, 1976 the court dismissed the trustee's contention that § 2–702(2) was a statutory lien voidable under § 67c or a priority

which would evade the provisions of § 64a, and granted reclamation. In arriving at its decision the court considered several cases and an authority to the contrary. (See *In re Good Deal Supermarkets, Inc.*, 384 F. Supp. 887 (D.N.J. 1974) and *In re Federal's Inc.* 12 UCC Rep. Serv. 1142 (E.D. Mich. 1973) and *Countryman*, Buyers and Sellers of Goods in Bankruptcy, 1 New Mexico Law Rev. 435 (1970).

Thus, we have what will ultimately result in a conflict between the circuits to be resolved by the Supreme Court, but regardless of such determination either way, the question reduces itself to an inquiry as to whether the objectives of the Banyruptcy Act are best served by such a determination or whether a new concept of this problem, more consistent with the every day reality of business dealings between debtor and creditors, should be adopted.

Since our office has been involved in a number of cases dealing with present day reclamations and some prior to the enactment of § 2–702(2), Mr. H. Stephen Edelman of our firm and I did some research in this connection which we propose to publish in the near future. Our thoughts in this area may be briefly summarized.

A. THE HOUSE APPENDIX VERSION

The return to the common law rule of fraud is fraught with all the old litigious problems of intentional and tacit concealment, false testimony, delay in obtaining restitution and difficulity of tracing proceeds where the property has been sold. Prof. Williston [5 Williston Contracts (Rev. Ed.) § 1492 N. 10] cites a number of instances where recovery was allowed at common law on such flimsy representations as: a man was doing a "safe business," a note was "as good as the Bank of England" (probably non-actionable today); "a corporation was doing a good business"; a buyer "was safe to be trusted and given credit." The representations can be as fluid as the buyer's tongue or the seller's machinations.

The proposed action has no time limit upon recovery of the goods regardless of the date of receipt, and since the representation may be based on the date of contract for the goods or the date the order is given, months may elapse between such date and actual delivery, resulting in a favored treatment being given to many creditors (*See California Conserving Co.* v. *D'Avanzo*, 62 F. 2d 528 (1933).

Professor Kennedy (Trustee in Bankruptcy under U.C.C., etc. 1 Coogan-Hogan-Vagts, Secured Transactions Under U.C.C. § 10.04 at 1091) states the purpose of § 2–702:

"Section 2–702(2) undertakes to cut a clean, new path in dealing with a seller's right to recover goods for fraud after they have been delivered to a buyer * * *. Subsection (2) takes as its base line the proposition that any receipt of goods on credit by an insolvent buyer amounts to a tacit misrepresentation of solvency and therefore is fraudulent as against the particular seller * * *."

What happens then to this "clean, new path?" Moreover, what common law rule is applied? Obviously, each state has its own common law and each reclamation will have to be based on the common law rule existing in the state where the contract was entered into. But today all states (except Louisiana) have supplanted the common law with the Code. Accordingly, there is no common law to apply [See Note, 35 U. of Pittsburgh L.R. 922, 933 (1974)].

Professor Gilmore (Legal Realism" Its Cause and Cure, 70 Yale L.J. 1037, 1046 (1961) states in this connection:

"A 'code', let us say, is a legislative enactment which entirely pre-empts the field and which is assumed to carry within it the answers to all possible questions * * * the pre-Code common law is no longer available as an authoritative source * * *."

And then with a quip at international economy, he observes:

"One thing does become clearer with each decade—going off the common law standard is like going off the gold standard—you can never go back * * *"

The court in *In re Behring & Behring*, 5 UCC Rep. Serv. 600, 605 (Unreported, Aff'd—D.C. Tex—1968) cites with approval a comment of Professor Shanker in a paper delivered at the National Conference of Referees in Bankruptcy:

"It is his conclusion with which I agree that: 'The present version (of the U.C.C.) makes clear that § 2–702 has pre-empted the field entirely and that if a seller wishes to reclaim, he may do so only pursuant to § 2–702 along with whatever 'lien creditor' limitations are found therein; and that a seller

may no longer even try to argue that he has additional common law rescission rights based on fraud on top of his statutory rights under § 2–702.' "

Is there an Erie v. Tompkins, 304 U.C. 64 (1938) problem with state law providing a Code remedy and the Bankruptcy Act providing a common law remedy? (See Kennedy § 10.03[4] at 1073, supra.)

Professor Gilmore (supra at 1046) states:

"*Erie* seemed to announce that state law should prevail, unless displaced by a federal statute, and that there should be no competing federal common law * * *."

If the House appendix version is approved and the common law of each state (Louisiana excepted) has been supplanted by the Code, what law will be applied? Will there be an unearthing of federal common law notwithstanding *Erie?* Will there be one set of rules for state reclamations and another for the federal courts? Will Code reclamations under state law be invalid as preferences under the Bankruptcy Act because proof will ignore common law rules? The rhetorical questions indicate the resulting confusion with answers which at best would be unsatisfactory.

B. THE SENATE STAFF'S DRAFT

The Senate Staff's Draft on the other hand correlates state law with the Bankruptcy Act. However, omitted is the three months' period of notification where the misrepresentation is in writing and the restriction of the rights of a seller against a buyer in the ordinary course or other good faith purchaser as well as the exclusion of all other remedies upon successful reclamation.

A fourth proviso would be more consistent with the law of contracts and avoid litigation by including the omitted provisions of § 2–702(3), but indicating that a creditor holding a security interest in inventory or receivables should not be considered a bona fide purchaser for the purposes of this section. This would eliminate the inequity of a secured creditor receiving a windfall which ultimately would benefit the debtor by increasing his asset position and overcome the holding in *First-Citizen Bank & Trust Co.* v. *Academic Archives, Inc.*, 179 S.E. 2d 850 (N.C. Ct. of Appeals, 1971), 8 UCC Rep. Serv. 1197, 1201, that "the holder of a perfected security interest in after acquired property qualifies as a 'good faith purchaser' " and therefore, cuts off the rights of a reclaiming creditor by virtue of § 2–702(3).

C. PROBLEMS OF SECTION 2–702(2) WITH REFERENCE TO CHAPTER PROCEEDINGS

The problem of reclamation of goods is accentuated in the chapter proceedings where a debtor, desirous of continuing operations, must keep ordering goods even though he contemplates in a week or two, that he may have to file a petition under Chapter X or XI. Delay in filing is occasioned by the necessity of convening directors for a meeting, providing for financing, preparing key executives for operations as a debtor in possession and a host of housekeeping problems. Perplexed with this problem officers of an insolvent are on the horns of a dilemma. If they order goods which are not paid for because of the filing of a petition, their conduct constitutes not only a misrepresentation which is inimical to their dealings with the creditors, but actionable fraud and deceit; but if they do not order the goods because of imminent bankruptcy, the business will suffer for lack of continuity. Discussing the problem of bona fides involved in the ordering of goods by an insolvent debtor Professor Henson (Henson, Reclamation Rights of Seller Under § 2–702, 21 N.Y.L. Forum 41, 49 (1975)) observes:

" * * * While one may occasionally hesitate to question publicly the bona fides of an insolvent who files for relief, in bankruptcy or otherwise, it simply surpasses belief that a buyer can honestly expect—quite apart from any presumed intention—to pay for goods while insolvent, and no seller would knowingly deliver goods in such circumstances. There is an overwhelming aura of fraud here * * *. The situation smells * * *."

Trade creditors, too, have a stake in the debtor's operations, not only because of their monetary interest, but also because of their desire to continue their business relationship with the debtor in possession. Confronted with this problem, a debtor must be free to purchase goods immediately before bankruptcy but the creditor must have some assurance of payment. A delicate balance must be made between these equities.

With the growth of the economy in the past two decades, reclamations have become numerous in chapter cases and it is not unusual for debtors having many outlets to which deliveries are made, to be confronted with a dozen or more reclamation proceedings. Indeed, several current cases have indicated an interest in balancing the equities between debtor and creditor, ignoring arbitrary lines of demarcation as a basis for recovery such as notification by seller, possession and identification of goods at time of demand and tracing of proceeds. This compromise generally has consisted of granting a priority to the separate class of creditors who shipped goods within ten days of the filing of the petition, regardless of the requirements of the fine legal points mentioned above.

Thus, in the *Matter of Filigree Foods, Inc.*, (unreported, D.N.J. Docket # B-75-1123), provision was made in the plan for an additional payment to those creditors who filed applications for reclamation of goods pursuant to § 2-702(2) of the Uniform Commercial Code as an alternative to continued litigation. Similar provisions were contained in a plan submitted to creditors in the *Matter of Associated Food Stores, Inc.* (unreported, E.D.N.Y. Docket # 75 B-1391). The provisions of this plan provide that in addition to the sums payable to general creditors, a further sum will be distributed to "all creditors who . . . shipped within ten (10) days of the filing of the petition" to debtor's warehouse, or to the debtor's members of a cooperative. In *Matter of the Bohack Corporation* (Unreported (E.D.N.Y. Docket # 74-B-933), a separate class was established for payment to reclamation creditors.

C. CONCLUSION

The enactment of an amendment to Chapter IX of the Bankruptcy Act includes a provision for dealing with the problem of current sales and services to municipalities granting such creditors a priority in payment. For the reasons herein set forth, we suggest that a creditor delivering merchandise to a debtor, which is received within ten (10) days of the filing of the petition, be granted an administration claim based on his contract rights. The proposal to allow him an administration claim is based on the premise that he is surrendering his right to immediate possession of his goods. In other words, he has a valuable right of immediate reimbursement through the sale of his goods. (See Shanker, The Worthier Creditors (And a Cheer for the King), 1 Canadian Business Law Journal 341, August 1976, suggesting a new method for evaluation of priorities.

Such an amendment would eliminate the litigation involved in reclamation proceedings based on a false representation of debtor's financial condition. Indeed, the current cases where reclamation has been sought are replete with numerous problems which arise in reclamation proceedings whether the House's Appendix version or the Senate's Staff version is adopted. The granting of a limited 10 day priority would eliminate costly, time-consuming litigation and resolve the dilemma of ordering goods by an insolvent buyer with knowledge that he cannot pay.

II

We are also concerned with § 4-208 (Protection of the Estate, Debtor and Third Persons). Assume an involuntary petition seeking bankruptcy liquidation is filed. Several alternatives are open to the debtor and creditors: (1) debtor may consent to the relief sought in the petition; or (2) the court may hold a hearing to determine whether the relief sought is in the best interests of the debtor and its creditors * * *. If the court determines that it is not, the case shall be dismissed * * *."

No options are given the debtor in such case, to file a petition seeking relief under Chapter VII. The beneficial features of Chapter X, § 127 and Chapter XI, § 321, giving a debtor the exclusive right to file such a petition, are lost (See Rule 10-105(d) and Rule 11-7 providing for a stay of adjudication and administration of the estate.)

III

Our final concern is with the Appendix amendment to § 7-203 adding a new subdivision (c) as to use of inventory accounts and chattel paper by a debtor

or trustee. As originally proposed by the Bankruptcy Commission, this subdivision did not exist. It is obvious that such a restriction would result in irreparable harm to the reorganization process. All operations of a debtor would cease upon the filing of a petition, including the selling or manufacturing of goods and even collecting accounts receivable so as to have adequate working capital for operational purposes.

Indeed, this amendment may prove counterproductive to the secured creditor, because upon cessation of operations, the collateral would be considerably diminished. Moreover, reorganization would never be possible if a debtor's operations had to await a determination by the court, after notice to the secured creditor, that "the value of the secured party's interest in such property as of the date of the petition is adequately protected." As to the comprehensive nature of such a hearing, the problem involved and the time for trial and consideration by the court, see *In re American Kitchen Foods, Inc.*, 2 Bankr. Ct. Dec. 715, 722 (appendix).

We believe that a far more satisfactory answer to the problem is to continue the automatic stay and put the initiative upon the secured creditor to file a complaint objecting to the continued use of such collateral. He can do this immediately upon the filing of the petition. Continued operation can only inure to the benefit of the secured creditor who has always been anxious to dispose of his collateral in a commercially reasonable manner.

We hope our comments will be of assistance to you in arriving at a solution to these problems, and in this connection, feel free to call upon us.

Sincerely yours,

BENJAMIN WEINTRAUB.
H. STEPHEN EDELMAN.

APPENDIX

"It is little more than the articulation of an unexceptionable business judgment to hold that, wherever practicable, conversion in the ordinary course of business should be considered the most commercially reasonable collateral disposition, simply because and to the extent that it is more productive. Where collateral includes inventory and receivables the distinction can be of enormous significance. While its business is operating, a Chapter XI debtor can continue to convert receivables at face value and sell inventory at market. *Once business operations cease, receivables and inventory will return* [*30*] *only a disappointing fraction of their value,* particularly if they have to be liquidated in ordinary bankruptcy proceedings. It would be inept to ignore and prodigal to decline that collateral margin in the rehabilitation process." [Italics ours.]

NATIONAL CONFERENCE OF BANKRUPTCY JUDGES,
Bangor, Maine, February 3, 1977.

Senator QUENTIN N. BURDICK,
Old Senate Office Building,
Washington, D.C.

DEAR SENATOR BURDICK: I am pleased to transmit final results of the first nationwide caseload survey ever undertaken to determine the dollar dimensions of proceedings pending before the federal bankruptcy courts. At a time when comprehensive revision of our federal bankruptcy law is receiving unpredecented congressional attention under your leadership, these data, which were gathered by the National Conference of Bankruptcy Judges under the direction of Judge David A. Kline of Oklahoma City, Oklahoma, should yield much needed insight into the enormous economic impact of federal insolvency proceedings.

I would be happy to supply whatever additional quantities of these reports you may wish and am making available copies to Thomas L. Burgum and Robert E. Feidler directly.

Respectfully,

CONRAD K. CYR,
U.S. Bankruptcy Judge.

Enclosure.

NATIONWIDE SURVEY OF BANKRUPTCY COURT CASELOAD

Circuit	Cases	Creditors	Assets	Liabilities
1st	9,766	312,500	$2,805,474,441	$3,836,379,978
2d	24,888	1,443,455	3,858,746,409	6,899,249,107
3d	11,477	388,062	1,777,321,260	2,881,777,113
4th [1]	19,645	430,211	1,320,446,277	2,083,173,537
5th [2]	39,362	1,352,795	4,787,894,849	7,809,996,354
6th	31,724	1,287,043	2,027,003,747	3,095,565,842
7th [3]	20,553	558,189	1,754,698,146	3,678,095,284
8th	17,615	651,922	1,221,767,048	1,723,547,693
9th	62,975	2,221,412	6,079,866,284	8,888,253,832
10th [4]	13,275	472,351	1,351,237,609	2,031,659,958
District of Columbia	383	12,792	55,404,621	60,117,777
Total	251,663	9,130,732	27,039,860,691	42,987,816,475

[1] Does not include data for the District of Maryland.
[2] Includes incomplete data for the Northern District of Texas. Does not include data for the Southern District of Georgia.
[3] Does not include data for the Eastern District of Michigan.
[4] Includes incomplete data for the District of Montana.

Note.—Except as otherwise noted, the survey reflects actual scheduled assets and liabilities in all cases pending as of Oct. 31, 1976, under ch. I-VII (straight bankruptcy), ch. X (corporate reorganization), ch. XI (business arrangements) and ch. XII (real property arrangements). The data for ch. XIII are incomplete.

[From the Congressional Record, Dec. 10, 1975]

H.R. 10624, as Passed by the Senate, Dec. 10, 1975

So the bill H.R. 10624, as amended, was passed, as follows:

Strike out all after the enacting clause and insert:

That the Bankruptcy Act of 1898 (30 Stat. 544), as amended, is hereby amended to add a new chapter XVI thereto reading as follows:

"Chapter XVI—Adjustment of Indebtednesses of Major Municipalities

"JURISDICTION, POWERS OF THE COURT, AND RESERVATION OF POWERS

"Sec. 801. (a) This Act and proceedings thereunder are found and declared to be within the subject of bankruptcies and, in addition to the jurisdiction otherwise exercised, courts of bankruptcy shall exercise original jurisdiction as provided in this chapter for the composition or extension of the debts of certain public agencies of instrumentalities or political subdivisions. The court in which the petition is filed in accordance with subsection 804(c) shall exercise exclusive jurisdiction for the adjustment of petitioner's debts and, for

purposes of this chapter, shall have exclusive jurisdiction of petitioner and its property, wherever located.

"(b) Upon the filing of a petition the court may, in addition to the jurisdiction, powers, and duties hereinabove and elsewhere in this chapter conferred and imposed upon it (1) permit the rejection of executory contracts of the petitioner, upon notice to the parties to such contracts and to such other parties to such contracts and to such other parties in interest as the court may designate, (2) exercise such other powers not inconsistent with the provisions of this chapter.

"(c) Upon the filing of a petition the chief judge of the court in the district in which the petition is filed shall immediately notify the chief judge of the circuit court of appeals of the circuit in which the district court is located, who shall designate the judge of the district court to conduct the proceedings under this chapter.

"(d) Nothing contained in this chapter shall be construed to limit or impair the power of any State to control by legislation or otherwise, any public agency or instrumentality or political subdivision of the State in the exercise of its political or governmental powers, including expenditure therefor: *Provided, however*, that no State law prescribing a method of composition of indebtedness of such agencies shall be binding upon any creditor who does not consent to such composition, and no judgment shall be entered under such State law which would bind a creditor to such composition without his consent.

"(e) Subsections 60 (a), (b), (c), section 67, and subsections 70 (c), (e) of this Act shall apply in proceedings under this chapter, except that all functions of the trustee thereunder shall be assumed by the petitioner.

"DEFINITIONS

"SEC. 802. The words and phrases used in this chapter have the following meanings unless they are inconsistent with the context:

"(1) The term 'attorney' means an attorney licensed to practice law by any State and includes a law partnership or corporation.

"(2) 'Claims' shall include bonds, notes, judgments, and demands, liquidated or unliquidated, and other evidence of indebtedness, either secured or unsecured, and certificates of beneficial interest in property.

"(3) The term 'court' means United States district court sitting in bankruptcy, and the terms 'clerk' and 'judge' shall mean the clerk and judge of such court.

"(4) The term 'creditor' means any person who owns a claim against the petitioner and any person injured by the rejection of an executory contract or an unexpired lease pursuant to this chapter or an unexpired lease pursuant to this chapter or pursuant to a plan under this chapter, and may include such person's authorized agent.

"(5) The term 'lien' means a security interest in property, a lien obtained on property by levy, sequestration or other legal or equitable process, a statutory or commonlaw lien on property, or any other variety of charge against property to secure performance of an obligation.

"(6) The term 'plan' means a plan proposed in a case under this chapter.

"(7) The term 'person' includes a corporation or a partnership, the United States, the several States, and public agencies, instrumentalities, and political subdivisions thereof.

"ELIGIBILITY FOR RELIEF

"SEC. 803. (a) Any municipality public agency, instrumentality, or political subdivision of the State is eligible for relief under this chapter, if the municipality is first specifically authorized to file a petition initiating a proceeding under this chapter by the chief executive, legislature, or such other governmental officer or organization empowered under State law to authorize the filing of such a petition.

"(b) Any public agency or instrumentality or political subdivision subordinate to such municipality or whose responsibilities are restricted to the geographical limits thereof, including incorporated authorities, commissions and districts, for whose debts such municipality is not otherwise liable, is eligible for relief as a separate petitioner and a petition seeking relief shall be jointly administered in the same proceeding in which such municipality seeks relief

under this chapter if such agency, instrumentality, or subdivision is not prohibited from filing a petition by applicable State law.

"PETITION AND FILING

"SEC. 804. (a) Any entity eligible for relief under section 803 may file a voluntary petition under this chapter. The petition shall state that the petitioner is eligible to file a petition, that the petitioner is insolvent or unable to pay its debts as they mature, and that it desires to effect a plan for the composition or extension of its debts. The petitioner shall file with its petition, or within such time as the court may prescribe, lists of its creditors and of other persons who may be adversely affected by a proposed plan and if an identification of all the petitioner's creditors is impracticable, the petitioner shall state the reason therefor.

"(b) The petition shall be filed with any court in whose territorial jurisdiction the municipality or any part thereof is located, and shall be accompanied by payment to the clerk of a filing fee of $100, which shall be in lieu of the fee required to be collected by the clerk under other applicable chapters of this title, as amended.

"STAY OF PROCEEDINGS

"SEC. 805. (a) A petition filed under section 804 shall operate as a stay of the commencement or the continuation of any court or other proceeding against the petitioner, its property or any officer or inhabitant of the petitioner, or which seeks to enforce any claim against the petitioner; as a stay of any act or the commencement or continuation of any court proceeding to enforce any lien on taxes or assessments, or to reach any property of the petitioner; and as a stay of application of any setoff or enforcement of any obligation of the petitioner.

"(b)(1) A petition filed by a petitioner eligible for relief under this chapter shall operate to stay recognition or enforcement of the setoff of any claim owing by the petitioner effected or attempted to be effected within three months prior to the date of the petition or thereafter against any obligation owing to the petitioner until the stay is terminated by the court or the case is dismissed. Such stay shall not affect the right of the creditor to withhold payments to or on the order of the petitioner, except when otherwise ordered pursuant to subdivision (2).

"(2) After hearing on notice to the person asserting the right of setoff, the court may order such persons to pay to the petitioner or to its order the amount of the obligation sought to be offset if the stay is not terminated pursuant to subdivision (d). However, the court may require as a condition of the order that the petitioner furnish such protection as will adequately protect the person who is asserting the right of setoff.

"(c) Except as its may be terminated, annulled, modified, or conditioned by the court under the terms of this section, the stay provided for herein shall continue until the case is closed or dismissed or the property subject to the lien is, with the approval of the court, abandoned or transferred.

"(d) On the filing of a complaint seeking relief from a stay provided in this section, the court shall set a hearing for the earliest possible date. The court may, for cause shown, terminate, annul, modify, or condition such stay.

"(e) The commencement or continuation of any act or proceeding other than described in subsection (a) of this section may be stayed, restrained, or enjoined pursuant to rule 65 of the Federal Rules of Civil Procedure, except that a temporary restraining order or preliminary injunction may be issued without compliance with subdivision (c) of that rule.

"(f) A provision in a contract or lease, or in any law applicable to such a contract or lease, which terminates or modifies, or permits a party other than the petitioner to terminate or modify the contract or lease because of the insolvency of the petitioner or the commencement of a case under this Act is not enforceable if any defaults in prior performance of the petitioner are cured and adequate assurance of future performance is provided.

"(g) No stay, order, or decree of the court may interfere with (1) any of the political or governmental powers of the petitioner; or governmental powers of the petitioner; or (2) any of the property or revenues of the petitioner necessary for essential governmental purposes; or (3) the petitioner's use or enjoyment of any income-producing property: *Provided, however*, That the

court shall enforce the conditions attached to certificates of indebtedness issued under section 811 and the provisions of the plan.

"CONTEST AND DISMISSAL OF PETITION

"SEC. 806. (a) Any creditor may file a complaint in the bankruptcy court contesting the petition for relief under this chapter. The complaint may be filed within thirty days following the filing of the petition.

"(b) The court may, upon notice to the creditors and a hearing following the filing of such a complaint, dismiss the proceeding if it finds that the petition was not filed in good faith or that it does not meet the provisions of this chapter.

"(c) A finding of jurisdiction shall be considered an interlocutory order for purposes of appeal. No appeal pursuant to section 1292 of title 28, United States Code, shall be allowed.

"NOTICES

"SEC. 807. (a) The petitioner or such other person as the court shall designate shall give prompt notice of the commencement of a proceeding or dismissal of the petition under this chapter to the State in which the petitioner is located and to the Securities and Exchange Commission and to creditors. As creditors and other persons who may be materially and adversely affected by the plan are identified, the petitioner or such other person as the court shall designate shall give such persons notice of the commencement of the proceeding, a summary of the provisions of the plan and any proposed modification of the plan and any proposed modification of the plan, and of their right to request a copy of the plan, or modification. The notice required by the first sentence of this subsection shall be published at least once a week for three successive weeks in at least one newspaper of general circulation published within the jurisdiction of the court, and in such other papers having a general circulation among bond dealers and bondholders as may be designated by the court. The court may require that it be published in such other publications as the court may deem proper.

"(b) The petitioner or such other person as the court shall designate shall also give notice to all creditors of the time permitted for accepting or rejecting a plan or any modification thereof. Such time shall be ninety days from the filing of the plan or modification unless the court for good cause shall set some other time.

"(c) The petitioner or such other person as the court shall designate shall also give notice to all creditors (1) of the time permitted for filing a complaint objecting to confirmation of a plan, (2) of the date set for hearing objections to such complaint, (3) of the date of hearing of a complaint, seeking dismissal of the petition, and (4) of the date of the hearing on confirmation of the plan.

"(d) All notices given by the petitioner or such other person as the court shall designate shall be given in the manner directed by the court; however, the court may issue an order at any time subsequent to the first notice to creditors directing that those persons desiring written notice file a request with the court. If the court enters such an order persons not so requesting will receive no further written notice of proceedings under the chapter.

"(e) Cost of notice shall be borne by the petitioner, unless the court for good cause determines that the cost of notice in a particular instance should be borne by another party.

"REPRESENTATION OF CREDITORS

"SEC. 808. (a) For all purposes of this chapter any party in interest may act in person or by an attorney or a duly authorized agent or committee. Where any committee, organization, group, or individual shall assume to act for or on behalf of creditors, such committee, organization, group, or individual shall first file with the court in which the proceeding is pending a list of the creditors represented, giving the name and address of each and describing the amount and character of the claim of each; copies of the instrument or instruments in writing signed by such creditors conferring the authority for representation; and a copy of the contract or contracts of agreement entered into between such committee, organization group, or individual and the represented creditors, which contract or contracts shall disclose all

compensation to be received, directly or indirectly for such representation, which agreed compensation shall be subject to modification and approval by the court.

"(b) The judge shall, for cause shown, permit a labor organization or employee association representative of employees of the debtor municipality, public agency, instrumentality, or political subdivision to be heard on the economic soundness of the plan affecting the interests of the represented employees.

"LIST OF CLAIMS AND PERSONS ADVERSELY AFFECTED

"SEC. 809. (a) The list of claims filed as required in section 804(a) shall include, to the extent practicable, the name of each known creditor to be materially and adversely affected by the plan, his address so far as known to the petitioner, and a description of each claim showing its amount and character, the nature of any security therefor and if the claim is disputed, contingent or unliquidated as to amount. With respect to creditors not identified, the petition shall set forth the reasons identification is not practicable, and shall specify the character of claim involved. The list shall be supplemented as petitioner becomes able to identify additional creditors.

"(b) If the proposed plan requires revision of assessments so that the proportion of special assessments or special taxes to be assessed against some real property will be different from the proportion in effect at the date the petition, is filed, the holders of record of title, legal or equitable, to such real property shall be deemed persons adversely affected and shall be similarly listed.

"(c) The court may for cause modify the requirements of subsections (a) and (b) of this section.

"PROOF OF CLAIM

"SEC. 810. (a) In the absence of an objection made by any party in interest, the claim of a creditor that is not disputed, contingent, or unliquidated, is established by the list of claims filed pursuant to section 809. The court may set a date by which proofs of claim of unlisted creditors and of creditors whose listed claims are disputed, contingent, or unliquidated, must be filed. If the court does not set such a date, the proofs must be filed before the entry of the order of confirmation. The petitioner or such other person as the court shall designate shall give notice to each person whose claim is listed as disputed, contingent, or unliquidated, in the manner directed by the court.

"(b) If an executory contract or an unexpired lease is rejected under a plan or under section 801(b), any person injured by such rejection may assert a claim against the petitioner. The rejection of an executory contract or unexpired lease constitutes a breach of the contract or lease as of the date of the commencement of the case under this chapter. The claim of a landlord for injury resulting from the rejection of an unexpired lease of real estate or for damages or indemnity under a covenant contained in such lease shall be allowed, but shall be limited to an amount not to exceed the rent, without acceleration, reserved by such lease for the next year succeeding the date of the surrender of the premises to the landlord or the date of reentry of the landlord, whichever first occurs, whether before or after the filing of the petition, plus unpaid accrued rent, without acceleration, up to the date of such surrender or reentry. The court shall scrutinize the circumstances of an assignment of a future rent claim and the amount of the consideration paid for such assignment in determining the amount of damages allowed the assignee of that claim.

"CERTIFICATES OF INDEBTEDNESS

"SEC. 811. At any time after a petition has been filed, the court may upon cause shown, authorize the petitioner to issue certificates if indebtedness for cash, property or other consideration, under such terms and conditions and with such security and priority in payment over existing obligations, secured or unsecured and other expenses of administration as the court may approve. Notwithstanding any other provision of law including section 821 of this chapter, the court shall have exclusive jurisdiction of any action which may be brought against petitioner to enforce compliance with the terms of any such certificates of indebtedness.

"PRIORITIES

"SEC. 812. The following shall be paid in full in advance of the payment of any distribution to creditors under a plan, in the following order:

"(1) The cost and expenses of administration which are incurred by the petitioner subsequent to the filing of a petition under this chapter.

"(2) Debts owed for services and materials directly provided within two months before the date of the filing of the petition under this chapter.

"(3) Debts owing to any person or entity, which by the laws of the United States (other than this Act) are entitled to priority.

"PROVISIONS OF PLAN AND FILING

"SEC. 813. (a) A petitioner's plan under this chapter may include provisions modifying or altering the rights of creditors generally, or of any class of them, secured or unsecured, either through issuance of new securities of any character, or otherwise, and may contain such other provisions and agreements not inconsistent with this chapter as the parties may desire, including, but not limited to provisions for the rejection of any executory contract and unexpired leases.

"(b) The petitioner may file a plan with its petition or as such later time as may be prescribed by the court.

"VOTING ON ACCEPTANCE OF PLAN

"SEC. 814. (a) A plan may me confirmed only if, of the creditors voting in writing to accept or reject the plan, those holding two-thirds in amount and 51 per centum in numbers of each class materially and adversely affected have voted to accept: *Provided, however*, That no such acceptance shall be required from any class which, under the plan, is to be paid in cash the value of its claims or is to be afforded such method of protection as will, consistent with the circumstances of the particular case, equitably and fairly provide for the realization of the value of its claims.

"(b) Unless his claim has been disallowed, any creditor who is included on the list filed pursuant to Section 809 or who files a proof of claim pursuant to section 810 is entitled to vote to accept or reject a plan or modification thereof within the time set pursuant to subsection 807(b). Claims owned, held or controlled by the petition are not eligible to vote.

"(c) For the purposes of the plan and its acceptance, the court may fix the division of creditors into classes and, in the event of controversy, the court shall after hearing upon notice summarily determine such controversy.

"(d) If any controversy shall arise as to whether any creditor or class of creditors shall or shall not be materially and adversely affected, the issue shall be determined by the judge, after hearing, upon notice to the parties interested.

"MODIFICATION OF PLAN

"SEC. 815. Before a plan is confirmed, changes and modifications may be made therein after hearing and upon such notice to creditors as the judge may direct, subject to the right of any creditor who has previously accepted the plan to withdraw his acceptance in writing, within a period to be fixed by the judge, if, in the opinion of the judge, the change or modification will materially and adversely affect such creditor; and if any creditor having such right of withdrawal shall not withdraw within such period, he shall be deemed to have accepted the plan as changed or modified: *Provided, however*, That the plan as changed or modified shall comply with all the provisions of this chapter and shall have been accepted in writing by the petitioner.

"STANDING TO OBJECT TO PLAN

"SEC. 816. Any creditor or other person materially and adversely affected by the plan may file a complaint with the court objecting to the confirmation of the plan. Such complaint may be filed any time up to ten days before hearing on the confirmation of the plan or within such other time as prescribed by the court. The complaint shall be served on the petitioner and such other persons as may be designated by the court.

"HEARING ON CONFIRMATION OF PLAN

"SEC. 817. (a) Within a reasonable time after the expiration of the time within which a plan and any modifications thereof may be accepted or rejected, the court shall set a hearing on the confirmation of the plan and modifications, and the petitioner and such other persons as may be designated by the court shall give notice of the hearing and time allowed for filing objections as provided in section 897(c).

"(b) Before concluding the hearing on confirmation of the plan the judge shall inquire whether any person promoting the plan or doing anything of such a nature, has been or it to be compensated, directly or indirectly, by both the petitioner and any creditor, and shall take evidence under oath to ascertain whether any practice obtains. After such examination the judge shall make an adjudication of this issue, and if he finds that any such practice obtains, he shall forthwith dismiss the proceedings and tax all of the costs against such persons, or against the petitioner, unless such plan be modified within the time to be allowed by the judge so as to eliminate the possibility of any such practice.

"(c) The court shall confirm the plan if satisfied that (1) it is fair, equitable, feasible, and not unfairly discriminatory in favor of any creditor or class of creditors; (2) it complies with the provisions of this chapter; (3) it has been accepted by creditors and provision has been made for nonaccepting creditors as required in section 814; (4) all amounts to be paid by the petitioner for services or expenses incident to the composition have been fully disclosed and are reasonable; (5) the offer of the plan and its acceptance are in good faith; (6) the petitioner is authorized by law to take all action necessary to be taken by it to carry out the plan; and (7) it appears from petitioner's current and projected revenues and expenditures that the budget of the petitioner will be in balance within a reasonable time after adoption of the plan. If not so satisfied, the judge shall enter an order dismissing the proceeding.

"EFFECT OF CONFIRMATION

"SEC. 818. (a) The provisions of a confirmed plan shall be binding on the petitioner and on all creditors, whether or not they are affected by it, whether or not their claims have been listed, filed, or allowed and whether or not they have accepted the plan.

"(b) The confirmation of a plan shall extinguish all claims against the petitioner provided for by the plan other than those excepted from discharge by the plan or order confirming the plan.

"DUTY OF PETITIONER AND DISTRIBUTION UNDER PLAN

"SEC. 819. (a) Tthe petitioner shall comply with the provisions of the plan and the orders of the court relative thereto and shall take all actions necessary to carry out the plan.

"(b) Subject to the provisions of subsection (c), distribution shall be made in accordance with the provisions of the plan to creditors (1) whose proofs of claim have been filed and allowed or (2) whose claims have been listed and are not disputed. Distribution to creditors holding securities of record shall be made to the recordholders as of the date the order confirming the plan becomes final.

"(c) When a plan requires presentment or surrender of securities or the performance of any other act as a condition to participation under the plan, such action must be taken not later than five years after the entry of the order of confirmation. Persons who have not within such time presented or surrendered their securities or taken such other action shall not participate in the distribution under the plan. Any securities, moneys, or other property remaining unclaimed at the expiration of the time allowed for presentment or surrender of securities or the performance of any other act as a condition to participation in the distribution under a confirmed plan shall become the property of the petitioner.

"(d) A certified copy of any order or decree entered by the court in a case under this chapter shall be evidence of the jurisdiction of the court, the regularity of the proceedings, and the fact that the order was made. A certified copy of an order providing for the transfer of any property dealt with by the plan shall be evidence of the transfer of title accordingly, and, if recorded as

conveyances are recorded, shall impart the same notice that a deed, if recorded, would impart.

"(e) The court may direct the petitioner and other necessary parties to execute and deliver or to join in the execution and delivery of any instruments required to affect a transfer of property pursuant to the confirmed plan and to perform such other acts, including the satisfaction of liens, as the court may determine to be necessary for the consummation of the plan.

"DISMISSAL

"SEC. 820. The court shall enter an order dismissing the case after hearing on notice: (1) for want of prosecution; (2) if no plan is proposed within the time fixed or extended by the court; (3) if no proposed plan is accepted within the time fixed or extended by the court; or (4) if a confirmed plan is not consummated.

"RETENTION OF JURISDICTION

"SEC. 821. The court may retain jurisdiction of a proceeding under this chapter for such period as it determines necessary to assure execution of the plan and discharge of the securities issued under the plan.

"REFERENCE OF TISSUES AND COMPENSATION

"SEC. 822. (a) The judge may refer any special issues of fact to a referee in bankruptcy, or special master for consideration, the taking of testimony, and a report upon such special issues of fact, if the judge finds that the condition of his docket is such that he cannot take such testimony without unduly delaying the dispatch of other business pending in his court, and if it appears that such special issues are necessary to the determination of the case. Only under special circumstances shall reference be made to a special master who is not a referee in bankruptcy. A general reference of the case to a master shall not be made, but the reference, if any, shall be only in the form of requests for findings of specific facts.

"(b) The court may allow reasonable compensation for the services performed by any such special master who is not a salaried Federal employee, and the actual and necessary expenses incurred in connection with the proceeding, including compensation for services rendered and expenses incurred in obtaining the deposit of securities and the preparation of the plan, whether such work may have been done by the petitioner or by committees or other representatives of creditors, and may allow reasonable compensation for the attorneys or agents of any of the foregoing: Provided, however, That no fees, compensation, reimbursement, or other allowances for attorneys, agents, committees, or other representatives of creditors shall be assessed against the petitioner or paid from any revenues, property, or funds of the petitioner except in the manner and in such sums, if any, as may be provided for in the plan of adjustment. An appeal may be taken from any order making such determination or award to the United States court of appeals for the circuit in which the proceeding under this chapter is pending, independently of other appeals which may be taken in the proceeding, and such appeal shall be heard summarily.

"CONVERSION TO CHAPTER XVI

"SEC. 823. (a) A petitioner eligible for relief under chapter XVI who has filed a petition under chapter IX of this Act may at any time file an application to have the case proceed under chapter XVI; *Provided, however*, That any petition filed by a municipality, public agency, instrumentality or political subdivision of the State after the effective date of this Act must be filed under Chapter XVI of the Bankruptcy Act as added by this Act.

"(b) After hearing on notice to the petitioner, the Securities and Exchange Commission, creditors and such other persons as the court may direct, the court shall, it it finds that the case may properly proceed under chapter XVI of the Act, approve the application and order the case to proceed under that chapter.

"EFFECT ON OTHER LAWS

"SEC. 824. Any State law which directly or indirectly deprives the petitioner of the effect of confirmation under this chapter is invalid.".

SEC. 2. The table of organization of title 11, United States Code, is amended by inserting after the reference to chapter 15, the following:

"CHAPTER 16. ADJUSTMENT OF INDEBTEDNESS OF MUNICIPALITIES

SEPARABILITY

SEC. 3. If any provision of chapter XVI of the Bankruptcy Act as added by this Act, or the application thereof to any agency, instrumentality, or subdivision is held invalid, the remainder of the chapter, or the application of such provision to any other agency or instrumentality or political subdivision shall not be affected by such holding.

EFFECTIVE DATE

SEC. 4. This Act shall become effective as of the date of its enactment.

Insert the following preamble:

Whereas the Congress finds and declares this Act and proceedings thereunder providing for the composition of indebtedness of, or authorized by, municipalities to be within the subject of bankruptcies under article I, section 8, clause 4 of the United States Constitution: and

Whereas the Congress finds that the impracticability of existing Federal bankruptcy remedies for use by municipalities increases the likelihood of their default and will aggravate the adverse effects thereof; and

Whereas the Congress finds the financial disruptions and dislocations resulting from default of such municipalities without availability of a Federal procedure to restructure their indebtedness in such fashion as to avoid continuing insolvency would have a substantial adverse effect on interstate commerce within the meaning of article I. section 8. clause 3 of the United States Constitution, by reason of the commercial importance of the municipalities involved.

Amend the title so as to read: "An Act to amend the Bankruptcy Act to add a new chapter thereto providing by voluntary reorganization procedures for the adjustment of the debts of municipalities".

The preamble was ordered to be inserted in the bill.

The title was amended so as to read:

"A bill to amend the Bankruptcy Act to add a new chapter thereto providing by voluntary reorganization procedures for the adjustment of the debts of municipalities."

S. 582

TO AMEND SECTION 40 OF THE BANKRUPTCY ACT TO FIX THE SALARIES OF REFEREES IN BANKRUPTCY

THURSDAY, MAY 1, 1975

U.S. SENATE,
SUBCOMMITTEE ON IMPROVEMENTS IN JUDICIAL
MACHINERY OF THE COMMITTEE ON THE JUDICIARY,
Washington, D.C.

The subcommittee met, pursuant to recess, at 10:05 a.m., in room 2228, Dirksen Senate Office Building, Senator Quentin N. Burdick [chairman of the subcommittee] presiding.

Present: Senator Burdick [presiding].

Also present: Thomas L. Burgum, deputy counsel; Robert E. Feidler, research director; and Kathryn M. Coulter, chief clerk.

Senator BURDICK. The hearings today concern S. 582, a bill which would amend section 40 of the Bankruptcy Act. The purpose of this bill is to restore to the Congress the sole and exclusive authority to fix salaries of the full-time bankruptcy judges. It would also serve to implement the salary authorization made by Congress over 6 years ago.

Today, in spite of a record number of cases, not a single bankruptcy judge receives the maximum salary of $36,000 authorized by Congress in 1968. There is mounting evidence that the effect of the 6-year freeze is endangering the quality and effectiveness of the bankruptcy bench. If such is the case, this weakening of the bankruptcy bench could not come at a worse time. The volume and complexity of federal bankruptcy is rising to record heights in fiscal 1975. It seems altogether appropriate then to determine whether the salary level of bankruptcy judges has kept pace with the number and complexity of cases which they are called upon to handle in the bankruptcy courts.

The witnesses today are the Honorable Robert B. Morton, president, National Conference of Bankruptcy Judges; the Honorable Conrad Cyr, vice president, National Conference of Bankruptcy Judges; the Honorable Joseph Patchan, a bankruptcy judge from Ohio; the Honorable Joe Lee, a bankruptcy judge from Kentucky; and Daniel Cowans, a distinguished bankruptcy lawyer and a former bankruptcy judge from California.

Welcome to the subcommittee, gentlemen. You may proceed in any order that you wish and any written statements that you have will be made a part of the record; so ordered, without objection.

[A copy of S. 582 follows:]

[S. 582, 84th Cong., 1st sess.]

A BILL To amend section 40 of the Bankruptcy Act to fix the salaries of referees in bankruptcy

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) subdivisions a and b of section 40 of the Bankruptcy Act (11 U.S.C. 68) are amended to read as follows:

"a. The compensation of referees in bankruptcy shall be as follows:

"(1) Each full-time referee in bankruptcy shall receive a salary of $36,000 per annum, subject to adjustment pursuant to Public Law 90–206, title II, December 16, 1967 (81 Stat. 643).

"(2) Each part-time referee in bankruptcy shall receive a salary of not more than $18,000 per annum, subject to adjustment pursuant to Public Law 90–206, title II, December 16, 1967 (81 Stat. 643), and subject to further adjustment by the conference, in the light of recommendations of the councils, made after advising with the district judges of their respective circuits, and the Director. In fixing the amount of the salary to be paid to a part-time referee, consideration shall be given to the average number and types of, and the average amount of gross assets realized from, cases closed and pending in the territory which the part-time referee is to serve, during the last preceding period of ten years, and to such other factors as may be material.

"(3) Disbursement of salaries of referees shall be made monthly by or pursuant to order of the Director.

"b. The conference, in light of the recommendations of the councils, made after advising with the district judges of their respective circuits, and of the Director, may increase or decrease the salary of any part-time referee, within the limit prescribed in subdivision a(2) of this section, if there has been a material increase or decrease in the volume of business or other changes in the factors which may be considered material in fixing salaries."

(b) Subdivision d(2) of such section is amended to read as follows:

"(2) Any referee who has retired or been retired under the provisions of subparagraph (1) of this subdivision may, if called upon by a judge of a court of bankruptcy, perform such duties of a referee, conciliation commissioner, or special master under this Act, within the jurisdiction of the court, as he may be able and willing to undertake. The retired referee shall receive as compensation for his services, either full or part-time, the salary authorized for the referee serving the territory to which the retired referee is assigned. However, the rate of compensation of a retired referee assigned to serve on a full-time basis in the territory of a part-time referee shall be the rate for full-time service. Salaries authorized under this paragraph shall be subject to the provisions of section 13(b) of the Civil Service Retirement Act.

Senator Burdick. Who wishes to speak first?

STATEMENT OF HON. ROBERT B. MORTON, PRESIDENT, NATIONAL CONFERENCE OF BANKRUPTCY JUDGES, KANSAS; HON. CONRAD K. CYR, VICE PRESIDENT, NATIONAL CONFERENCE OF BANKRUPTCY JUDGES, MAINE; HON. JOSEPH PATCHAN, BANKRUPTCY JUDGE, OHIO; HON. JOE LEE, BANKRUPTCY JUDGE, EASTERN DISTRICT OF KENTUCKY; AND DANIEL R. COWANS, FORMER BANKRUPTCY JUDGE, SAN FRANCISCO, CALIF.

Judge Morton. Mr. Chairman, if I may open, I am Robert Morton, as you have mentioned, and I am a bankruptcy judge from Wichita, Kansas. I have served at the district of Kansas for the past 13 years.

First, I should like to have accepted or offered as our formal statement, Mr. Chairman, the document prepared by Judge Cyr, which is denominated: The Proposal To Amend the Bankruptcy Act, Section 40, subsections a and b. That we would like to have treated as our formal statement.

Senator BURDICK. It will be made a part of the record, without objection.

[The statement referred to above follows:]

INTRODUCTION

Long neglected subjects often require lengthy introduction. The subject of the salaries of bankruptcy judges is a case in point.

The salaries of bankruptcy judges are fixed by the Judicial Conference of the United States in the light of recommendations by the circuit councils (made after advising with the district judges and the Director of the Administrative Office) within the maximum authorized by and pursuant to specific standards expressly prescribed by Section 40a of the Bankruptcy Act.

The "Postal Revenue & Federal Salary Act of 1967" (2 U.S.C. § 351 *et seq.*) established the "Commission on Executive, Legislative, and Judicial Salaries," to conduct quadrennial reviews of the salary rates of designated federal judicial officers, including bankruptcy judges. The report of the 1968 "Salary Commission," although acting under the misconception that the bankruptcy judge merely hears evidence and reports back to the district judge, rather than that he finally decides cases and controversies, nonetheless recommended that bankruptcy judges receive salaries of $40,000 per annum, which was later reduced in Congress to $36,000, the present statutory maximum contained in Section 40a.

On November 1, 1969, the *Judicial Conference* of the United States *approved a statement of policy that the criteria prescribed by Section 40a should be eliminated from the Bankruptcy Act,* thus abolishing in actual practice the last vestige of the old fee system for compensating referees in bankruptcy.[1] The *Conference* at that time *expressly disapproved the congressionally mandated practice of fixing the salaries of full-time referees in bankruptcy on the basis of the standards prescribed in Bankruptcy Act Section 40(a).*[2] But the actual repeal or amendment of Section 40a was never pursued. Consequently, every full-time bankruptcy judge in the country now receives the same salary ($31,650), without regard to the standards prescribed by Section 40a of the Bankruptcy Act, which plainly mandates material factors to be considered by the Conference in the fixing of referees' salaries. It seems altogether appropriate, therefore, *that Congress revoke its delegation of the authority to fix the salaries of bankruptcy judges now that the circumstances which prompted that delegation and the conditions imposed upon its exercise no longer obtain.*

HISTORY AND LEGISLATIVE PURPOSE OF SECTION 40a

Congressional excision of the universally deplored fee system for compensating referees in bankruptcy by the Referees' Salary Act of 1946 has been widely and deservedly proclaimed as the most important development in bankruptcy administration since the enactment of the Chandler Act of 1938. The wisdom of that fundamental reform has never been challenged and the anticipated beneficial effects of the abolition of the old fee system have indeed made a significant contribution to the vastly improved public and professional image of the bankruptcy court system.

The legislative aim of Section 40a of the Bankruptcy Act, enacted as part of the Referees' Salary Act of 1946, was to prescribe standards deemed appropriate by Congress for application by the Judicial Conference in determining the salary of each referee in bankruptcy attaining or remaining in that office during the transition from the old fee system to a salary system. Congress determined that it would not be appropriate to permit every referee the same salary under the new system, due to huge discrepancies in their caseloads and geographical territories.[3] It was obviously impracticable for the Congress itself to monitor the

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[1] Report of Proceedings of Judicial Conference of the U.S., October 31–November 1, 1969, at 76 (Adm. Off. U.S. Courts 1969). *See also* Cyr, "The Referees' Salary & Expenses System: Blessed Be The Fee That Binds," 24 Pers. Fin. L.Q. Rep. 117 (1970). [Appendix D.]

At the suggestion of the National Conference of Bankruptcy Judges, the Judicial Conference recognized the fact that any court system which is dependent for its operational funding upon the fees which it collects from litigants is vulnerable to the severe criticism that it gives at least the appearance of partiality or bias, in that its judges may collectively experience direct economic benefits as a result of their decisions. Id.

[2] Id.

[3] *See* Chandler, "The Outlook Under the New Referee Act," 21 Ref. J. 9, 12 (1946). *See also* Appendix D *infra,* at 118.

bankruptcy system on a continual basis in order to fix the salaries of those who were appointed to the new office from among the 335 referees serving under the old system.[4] The only practical alternative was to delegate standby salary-fixing authority to the Judicial Conference, acting on the basis of surveys and recommendations of the Administrative Office of the United States Courts, the district courts and the circuit councils, in the light of specific statutory standards and maxima imposed by the Congress in Section 40a.[5]

For more than twenty years following the enactment of the Referees' Salary Act of 1946, the Judicial Conference invariably and without exception authorized most full-time referees to receive the maximum salary permitted by Section 40a.[6] It was not until 1969, the same year in which the Judicial Conference expressed its disapproval of and abandoned the salary-fixing standards prescribed by Section 40a, that it refused, for the first time in history and on grounds nowhere contemplated within the enabling provisions of Section 40a, to permit any referee to receive the maximum salary authorized by Section 40a. At its March 13–14, 1969 meeting the Judicial Conference authorized the salaries of most full-time referees to be increased to $30,000 as of April 1, 1969.[7] Thereafter, until November 1, 1972, the Conference kept the salaries of full-time bankruptcy judges at $30,000, a full $6,000 below the $36,000 allowable under Section 40a.[8] Effective November 1, 1972, all full-time bankruptcy judges were authorized salaries of $31,650, as the result of an obscure administration action taken by the Director of the Administrative Office of the U.S. Courts.

THE REGULATORY FRAMEWORK

Public Law 90–206 [9] established the "Commission on Executive, Legislative and Judicial Salaries," whose duties were to review the salary rates of designated federal officers, including referees in bankruptcy,[10] every four years and recommend salary changes to the President of the United States. The *law* creating the "Salary Commission" *specifically requires it to review* ". . . *the appropriate pay levels and relationships between and among the respective offices and positions* covered by such review." [11] The position of district judge [12] and that of referee in bankruptcy [13] are covered by such review, as is the position of commissioner of the court of claims.[14] The "Salary Commission" submitted its report to the President recommending a maximum salary for full-time referees in bankruptcy of $40,000, $20,000 for part-time referees,[15] $40,000 for commissioners of the court of claims,[16] $47,000 for district court judges,[17] and $50,000 for judges of

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[4] Id. at 12.

[5] Section 40a of the Bankruptcy Act (11 U.S.C. § 68a) reads as follows:

"Referees shall receive as full compensation for their services, salaries to be fixed by the conference, in the light of the recommendations of the councils, made after advising with the district judges of their respective circuits, and of the Director, at rates not more than $36,000 per annum for full time referees, and not more than $18,000 per annum for part-time referees. In fixing the amount of salary to be paid to a referee, consideration shall be given to the average number and the types of, and the average amount of gross assets realized from, cases closed and pending in the territory which the referee is to serve, during the last preceding period of ten years, and to such other factors as may be material. Disbursement of such salaries shall be made monthly by or pursuant to the order of the Director."

[6] The first statutory salary ceiling under the Referees' Salary Act, effective July 1, 1947, was immediately allowed to become effective as to all but 16 full-time referees. 22 Ref. J. 25 (1948). The $12,500 maximum authorized by the Act of July 7, 1952 was allowed to the bulk of full-time referees by Judicial Conference action in the Fall of 1952. 28 Ref. J. 8 (1954). The maximum $15,000 salary authorized by the Act of May 10, 1956 was approved by the Judicial Conference for most full-time referees in bankruptcy, effective October 1, 1956. Report of Proceedings of Judicial Conference of U.S., Sept. 19–20, 1956, at 18 (Adm. Off. U.S. Courts 1956). The statutory maximum $22,500 salary fixed by Public Law 88–426 (August 14, 1964) was approved for the overwhelming majority of referees by the Judicial Conference action of Sept. 23–24, 1964, and was rendered *retroactive* to June 30, 1964. Report of Proceedings of Judicial Conference of U.S., Sept. 23–24, 1964, at 71 (Adm. Off. U.S. Courts 1964).

See also Appendix "A" *infra.*

[7] Report of Proceedings of Judicial Conference of U.S., Mar. 13–14, 1969, at 17–19 (Adm. Off. U.S. Courts 1969).

[8] As amended by Pub. L. 90–206, § 225(j), 2 U.S.C. § 360, 81 Stat. 644.

[9] 2 U.S.C. § 351, et seq., 81 Stat. 642 (1967).

[10] Id. § 356(C).

[11] Id. § 356(D)(1).

[12] *See* 22 U.S.C. § 356(C) and Pub. L. 88–426 (Aug. 14, 1964), 78 Stat. 434.

[13] *See* Pub. L. 88–426 (Aug. 14, 1964), 78 Stat. 434.

[14] *See* note 12 supra.

[15] Report of the Commission on Executive, Legislative, and Judicial Salaries, at 3 (Dec. 2, 1968).

[16] Id.

[17] Id.

the court of claims.[18] On January 15, 1969, the President transmitted the following reduced salary recommendations to Congress:[19] full-time referees $36,000 maximum; part-time $18,000; commissioners of the court of claims $36,000; district judges $40,000; judges of the court of claims $42,500.[20] Since Congress took no contrary action, the recommendations of the President became effective with the first pay period beginning after the thirtieth day following the transmittal of the recommendations on January 15, 1969.[21]

The Bankruptcy Act itself authorizes the Judicial Conference to fix bankruptcy judges' salaries within the existing $36,000 statutory maximum in response to certain specified criteria and "such other factors as may be material."[22] In considering whether bankruptcy judges should be allowed to receive the maximum salary to which the Congress, in light of the recommendations of the 1968 "Salary Commission" and of the President of the United States, deemed the office entitled, *there are a number of "material factors" which merit consideration by reason of their peculiar pertinence to the salary problems of bankruptcy judges.*

1968 'SALARY COMMISSION' ACTION

The action of the 1968 'Salary Commission,' premised as it was on the erroneous notion that the bankruptcy judge sits in the capacity of a hearing examiner rather than as the trial judge of the bankruptcy court,[23] has since been rendered even less pertinent in its description of the duties of the office. With the passage of Public Law 91–467, the so-called 'Dischargeability Bill,' and the adoption of the Rules of Bankruptcy Procedure, the judicial responsibilities of bankruptcy judges have again been greatly expanded,[24] vesting the bankruptcy court and specifically the bankruptcy judge with jurisdiction to 'determine the dischargeability of the debts, and render judgments thereon,'[25] to conduct jury trials, to determine and punish for contempt and to issue writs of habeas corpus.[26] The Salary Commission's misconception of the duties and powers of bankruptcy judges, as well as recent congressional enlargements of the powers and duties of the office, *clearly constitute material considerations warranting prompt corrective salary action.*

RATIONALE OF THE JUDICIAL CONFERENCE ACTION

It is important as well as relevant to examine the rationale underlying the unprecedented refusal of the Judicial Conference to permit bankruptcy judges to receive the full salary authorized by Congress.

The only explanation which has ever surfaced as to why full-time bankruptcy judges' salaries originally were restricted to $30,000 in 1969, despite the $36,000 statutory maximum allowable, is that since district judges receive $40,000, the supposed 'traditional' 4 to 3 ratio between district judges' and referees' salaries could be maintained by allowing no more than $30,000 to referees. Without attributing any such arbitrary or capricious rationale to the salary action of the Judicial Conference, it should be observed that *any such approach to the fixing of referees' salaries would be both economically unjustified and historically unsound.*

In *economic terms*, which it is submitted are most relevant in any consideration of salaries, bankruptcy judges find themselves no more successful at spending or saving ratios than are district judges. In any comparative salary study, dollars rather than ratios must be the relevant criteria. Moreover, as an *historical matter*, the suggested 4 to 3 ratio between district judge and referee salaries

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[18] Id. The position of U.S. Magistrate was not among those positions subject to salary review by the Salary Commission, since it had not yet been created.

[19] 34 C.F.R. 2241, 2 U.S.C.A. § 358.

[20] Id.

[21] 2 U.S.C. § 359(1), 81 Stat. 644. The last Federal court officials to receive any salary increase were the referees in bankruptcy, whose salary increase was allowed to become partially effective Apr. 1, 1969. Report of Proceedings of Judicial Conference of U.S., Mar. 13–14, 1969, at 16 (Adm. Off. U.S. Courts 1969).

[22] *See* note 5 supra.

[23] In the Senate floor debate on H.R. 4160, the Referees' Salary Act, Senator James W. Huffman of Ohio, floor manager of the bill, said: "Under the Chandler Act, passed in 1938, the referee is the judge of the court of bankruptcy." 20 Ref. J. 105 (1946). *See* Appendix F infra.

[24] The trend itself is not of recent origin by any means. It was well developed and widely recognized prior to the passage of the now antiquated Chandler Act of 1938. *See* Hunt, "Referees' Compensation," 10 Ref. J. 48, 52 (1936).

[25] Pub. L. 91–467, §§ 1 and 8 (Oct. 19, 1970).

[26] *See, e.g.*, Rules 201(a)(3), 810, 913 and 920(a) of the Rules of Bankruptcy Procedure.

is a recent and short-lived historical accident, without precedent during the entire seventy-seven year history of the existence of the office of referee in bankruptcy.[27] The 'Salary Commission,' specifically charged with the statutory duty to determine such relationships, plainly rejected the notion of a 4 to 3 (or any other salary) ratio between the salaries of judges and referees.[28] The President and the Congress in turn on the basis of the Report of the 'Salary Commission' recommended a maximum salary for referees and district judges of $36,000 and $40,000 respectively.[29]

The Judicial Conference salary action of March, 1969 marked the first time in history when that body ever withheld the maximum salary allowable by statute from every bankruptcy judge and allowed it to none.[30] Therefore, the 1968 'Salary Commission' unquestionably had sound historical groups upon which to presume that whatever maximum salary was approved by Congress for bankruptcy judges as a result of the 1968 salary review would be authorized immediately by the Judicial Conference for the vast majority of full-time bankruptcy judges, just as every previous statutory maximum had been thus fully and immediately implemented.

Viewed in its historical perspective and in light of the legitimate assumption that the 1968 Salary Commission recommendations, as adjusted by Congress, represent compelling evidence of a firm legislative intention that $36,000 was the appropriate salary for full-time bankruptcy judges, continued refusal to implement the 1969 salary recommendations for bankruptcy judges seems more arbitrary than equitable.

Another and perhaps the principal rationale for the discriminatory salary treatment of bankruptcy judges is the equally inappropriate and ineffectual attempt to secure increased compensation for magistrates, a matter solely within the power of Congress to effect. Nothing could be more clear than the fact that neither Section 40a nor any other Act of Congress even remotely empowers the Judicial Conference to look to the compensation of magistrates as one of the criteria appropriate for consideration in fixing the salaries of bankruptcy judges.[31] On the contrary, the legislation creating and empowering the quadrennial Salary Commission expressly extends to that body alone the responsibility for recommending to Congress the appropriate rates and relationships of federal bankruptcy judges' salaries. *As a result of the only such salary review action yet implemented by Congress bankruptcy judges were legislatively authorized 90% of the salary of a district judge, a determination which should not continue to be susceptible of disregard by the Judicial Conference without legislative license.*

Nonetheless, the Judicial Conference has imposed a requirement of parity between the salaries of magistrates and bankruptcy judges. On October 28, 1971, the Judicial Conference expressly provided that the maximum salaries for bankruptcy judges and magistrates should be 75 to 80 per cent of the salary of a district judge.[32] In the event that this mandate for salary parity presumes that the functions of the two offices are essentially similar, the premise itself is invalid. The office of magistrate was only recently created and thus far almost exclusively encompasses non-adjudicatory functions, such as civil pretrials, criminal arraignments and omnibus hearings. The United States Supreme Court has held that the conduct of evidentiary hearings and decisions on habeas corpus petitions are beyond the jurisdiction of the magistrates.[33] By contrast, the jurisdictional ambit and adjudicatory duties of bankruptcy judges have been evolving and expanding for almost eighty years, by statute and procedural rule, to the point where bankruptcy judges today render final judgments on virtually all of the myriad cases and controversies which arise from the enormous volume of bankruptcy and arrangement cases filed each year.[34]

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[27] *See* Appendix B infra.
[28] *See* note 15 supra.
[29] *See* Appendix E infra.
[30] *See* note 6 supra.
[31] It is necessarily so, since the office of magistrate was not so much as a "gleam in the eye of its maker" in 1946, when Section 40a was enacted.
[32] Report of Proceedings of Judicial Conference of U.S., Oct. 28–29, 1971, at 65 (Adm. Off. U.S. Courts 1971).
[33] *Wingo* v. *Wedding*, — U.S. —; 41 L. Ed. 2d 879, 94 S. Ct. — (June, 1974). *But see* Appendix I for evidence of Judicial Conference insistence upon salary parity.
[34] The annual volume of all bankruptcy proceedings filed has hovered around 200,000 for a decade. But projected filings for the current fiscal year exceed 252,000 cases, an increase of 33% over the preceding year and more than 20% over the previous record high of 208,000 cases in fiscal year 1967.

'Comparability' is an appropriate factor for use in setting salaries, but it must be applied uniformly across the board by the Congress, which alone has the requisite facilities and authority to make such determinations.[35] The need is to balance the compensation levels of *all* members of the judiciary within a structure which bears its proper relationship to that of court clerks, federal commissioners, administrative law judges and other personnel in the top civil service grades. The extent to which the salaries of bankruptcy judges have been held below those of fairly 'comparable' positions by the actions of the Judicial Conference is revealing.[36]

ECONOMIC FACTORS MATERIAL TO SALARIES OF BANKRUPTCY JUDGES

These Judicial Conference salary actions have had an economic impact on bankruptcy judges which is both severe and irreparable. Since April, 1969, when the salary of a full-time bankruptcy judge was set by the Judicial Conference at a level of $30,000—20% below the maximum authorized by Congress, the purchasing power of that salary has eroded to $17,400, which is 23% below the $22,500 he was receiving in 1965.[37] Furthermore, even though corrective action were to be taken at once to restore their salaries to the statutory maximum, more than $30,000 will have been irretrievably lost by every full-time bankruptcy judge in the country, due to the six-year refusal of the Judicial Conference to permit implementation of the $36,000 salary authorized by Congress. Likewise, immediate congressional action returning these salaries to the statutory maximum historically allowed would at best give bankruptcy judges approximately the same purchasing power enjoyed in 1968.

But the harsh erosive effects of inflation alone do not indicate the full brunt of the economic impact of the Judicial Conference salary action on bankruptcy judges. As the "Salary Commission" itself expressly stated,[38] the matter of retirement benefits ought to be considered in any comparative salary study.[39] A compulsory contribution of 7% of the bankruptcy judge's gross annual salary is required to provide the relatively meager Civil Service retirement benefits available to him,[40] whereas district judges receive full salary upon retirement without having made any financial contribution whatever. *Even if Section 40a of the Bankruptcy Act did authorize the Judicial Conference to set the salaries of bankruptcy judges on the basis of a comparison with district judges' salaries, it would be patently unrealistic and unfair to ignore that each full-time bankruptcy judge must now contribute more than $2,200 each year toward his retirement fund.*[41]

THE JUDICIAL CONFERENCE SALARY SETTING FUNCTION

The Judicial Conference of the United States is singularly ill-equipped to exercise its salary-fixing authority in isolation from the Congress. The Conference generally meets but two days in March and two days in October of each year. It is comprised of twenty-five circuit and district judges who are concerned primarily with the administrative and judicial problems confronted in the effort to cope with the expanding caseloads of their own busy courts. The Conference functions through a number of committees, including its Bankruptcy Committee, whose decisions are almost invariably adopted by the Conference itself. It has been described as a "receptacle for committee reports," most of which are endorsed without review or question. *Fish, The Politics of Federal Judicial Administration*, at 265 (Princeton Press 1973).

Bankruptcy judges have never been permitted to appear either before the Conference or its Bankruptcy Committee. Of course, no bankruptcy judge has

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[35] Of course, the quadrennial salary review is the vehicle expressly created for that purpose.

[36] *See* Appendices G and H infra.

[37] A 42% cumulative inflation factor has been employed.

[38] *See* Report of the Commission on Executive, Legislative and Judicial Salaries, at 16 (December 1968).

[39] Yet the Commission was not charged with doing so. Id. Presumably, therefore, the Commission did not take into account the very substantial differences between the retirement programs of district judges and bankruptcy judges.

[40] The Judicial Conference itself has long recognized the inadequacies of the retirement program for bankruptcy judges. *See* Report of Proceedings of the Judicial Conference of U.S., Sept. 17–18, 1963, at 85 (Adm. Off. U.S. Courts 1963).

[41] Increasing the salary to $36,000 would mean an annual retirement contribution of over $2,500. Bankruptcy judges must also pay current income taxes on their retirement contribution.

been allowed membership on the Bankruptcy Committee, although no legal disability renders them ineligible for committee membership. Nor is any bankruptcy judge consulted or permitted to act in any advisory capacity either to the Conference or to its Bankruptcy Committee. It is hoped that an opening of appropriate communications with the Judicial Conference may develop in time. But in the meantime *the quality of the bankruptcy bench will inevitably deteriorate to unacceptable levels unless Congress reclaims its salary-fixing authority, so as to assure that bankruptcy judges can never again be singled out for the sort of salary treatment accorded them in recent years.*

THE STATE OF THE JUDICIARY

During more than two decades since the effective date of the Referees' Salary Act in 1947 the unvarying policy of the Judicial Conference in authorizing full-time bankruptcy judges to receive the maximum salary allowed by Congress under Section 40a was an important factor in attracting to the federal bankruptcy bench experienced attorneys, government prosecutors, law school professors and state court judges who were stimulated by the increasing volume and complexity of bankruptcy court litigation which inevitably followed in the wake of the dramatic expansion of the American open credit economy following World War II. No court, state or federal, can lay claim to so current a docket despite the dramatic increase in the volume and complexity of its caseload as can the federal bankruptcy court.[42] The enlarged and more complicated bankruptcy court caseload was processed by an experienced cadre of skilled judges who had left other professional pursuits for a career in the federal judiciary, one which showed reasonable promise of offering adequate financial security. *The inclusion of bankruptcy judges among those whose salaries were to be subjected to quadrennial review by the Commission on Executive, Legislative & Judicial Salaries was regarded as concrete evidence of a congressional commitment to assure reasonable salary treatment of bankruptcy judges along with other federal judges.*

Chief Justice Burger has warned that the entire federal judicial system is endangered by the present salary freeze. Resignations and early retirements are occurring in increasing numbers. Recruitment for vacancies is becoming more difficult. The reason, in the case of district judges, is that the five-year decline in the purchasing power of the dollar has reduced their $40,000 salary to an effective level of less than $25,000, at the same time that the purchasing power of bankruptcy judges' salaries was being reduced to about $17,000.

Three former law school professors, two former state court judges and one of the authors of the prestigious *Collier on Bankruptcy* have recently left the bankruptcy bench, primarily due to economic reasons. All have achieved enviable nationwide distinction in their judicial positions. Other bankruptcy judges are on the verge of returning to state courts or private practice in the absence of prompt relief from their present economic problems. In addition to those vacancies by resignation there is a normal attrition in the number of bankruptcy judges lost by death or retirement which has averaged twelve judges per year in recent years. Not surprisingly, the Bankruptcy Division of the Administrative Office of United States Courts advises that recruitment is already becoming markedly more difficult because qualified attorneys are apprehensive over the existing inadequacy and long-range prospects for salary relief and security for bankruptcy judges.

Any weakening in the calibre of the bankruptcy bench could not come at a worse time. The volume and complexity of federal bankruptcy litigation has already risen to heights never before experienced.[43] The chances that the saturation level may be reached in 1975 are indeed grim. *It is not reckless doomsaying to consider that a crisis could soon be reached which would seriously strain even the capacity of a fully manned and experienced bankruptcy court. Thus the growing demoralization among bankruptcy judges and the serious drain of our best and most experienced judges should be reversed without delay. Now is no*

[42] The caseload was 15 times greater in 1972 than in 1947, while the bankruptcy court staff increased by less than five times. The average referee handled 132 cases in 1947, whereas the average caseload of each bankruptcy judge twenty-five years later was 1,074. Report of the Commission on the Bankruptcy Laws of the U.S., H. Doc. 93–137 93d Cong., 1st Sess., Part I, at 2–3 (U.S. Gov't. Printing Off. Wash. D.C. 1973).

[43] The Administrative Office advises that filings in the first half of fiscal 1975 totalled 116,643 cases, an increase of 33.2% over the comparable period of fiscal 1974. At that rate, a conservative projection is that fiscal 1975 will witness total filings of 252,431 cases, as compared with 208,000 cases filed in fiscal 1967, the largest in history.

time to sacrifice the best talent on the bankruptcy bench merely because of the refusal of the Judicial Conference to permit bankruptcy judges to receive compensation in 1975 at a level responsibly determined to have been reasonable in 1969.

We do not expect that the Congress can rectify all of the salary inequities experienced by bankruptcy judges over the past several years. We do ask, however, that Congress not allow those inequities to be perpetuated indefinitely. Allowance of the full $36,000 salary withheld from bankruptcy judges since 1969 would help. *But a permanent return of the salary-fixing authority to the Congress would do even more to restore the confidence of bankruptcy judges and to preserve the important gains made in recent years in the quality and competence of the bankruptcy bench.* Since both the procedural design and the actual operation of the present apparatus for fixing the salaries of bankruptcy judges are models of inefficiency, duplication and overlapping of responsibility in Government, the Congress can make a significant contribution to improvements in judicial machinery at the same time it alleviates a substantial injustice by the prompt adoption of the proposed amendments to Bankruptcy Act § 40a and b.

APPENDIX B

RATIO AND DOLLAR SPREAD BETWEEN SALARIES OF DISTRICT COURT JUDGES AND REFEREES

	1946–52	1953–55	1955–56	1957–64	1965–69	1969 to date
District judges	$15,000	$15,000	$22,500	$22,500	$30,000	$40,000
Salary ratio: judge to referee	3–2	6–5	9–5	3–2	4–3	4–3
Dollar difference	$5,000	$2,500	$10,000	$7,500	$7,500	$10,000
Referees	$10,000	$12,500	$12,500	$15,000	$22,500	$30,000

APPENDIX C

	1946–49	1950–55	1955–64	1964–67	1967–69	1969 to date
Judges court of claims	$17,500	$17,500	$25,500	$33,000	$33,000	$42,500
Salary ratio	7–3	[1] 9–7	[1] 13–7	9–7	8–7	7–6
Dollar spread	$10,000	$3,500	$11,500	$7,000	$4,000	$6,500
Commissioners	$7,500	$14,000	$14,000	$26,000	$29,000	$36,000

[1] Approximately.

APPENDIX D

THE REFEREES' SALARY AND EXPENSE SYSTEM: "BLESSED BE THE FEE THAT BINDS"

(By Conrad K. Cyr)

Section 40c of the Bankruptcy Act,[1] originally enacted in 1946 as part of the Referees' Salary Act, created two separate and distinct trust funds in the United States Treasury, one to defray the cost of referees' salaries and the other to defray the expenses of referees' offices and the salaries of their clerical assistants. For reasons of administrative convenience, Section 40 was amended in 1959 so as to consolidate the two funds into one,[2] to be known as the Referees' Salary and Expense Fund. Section 40c.(4) provides that the various fees and expenses paid over to the clerk of court to defray the costs of the salary and expenses of the referee are to be covered into the United States Treasury for the account of the Referees' Salary and Expense Fund.

The language of the Referees' Salary Act evidences the intent of Congress that the bankruptcy system be self-sustaining.[3] In fact, an excerpt from the report

[1] 11 U.S.C. § 68c.

[2] 73 Stat. 259 (1959).

[3] "The salaries of the referees in active service and the expenses of the referees, including the salaries of their clerical assistants, shall be paid out of annual appropriations from such salary and expense fund, by the United States. Any deficiencies of such salary and expense fund shall be paid out of any funds in the Treasury of the United States not otherwise appropriated, and appropriations to pay such deficiencies are hereby authorized: Provided, however, that there shall be covered into miscellaneous receipts of the Treasury of the United States in any subsequent year so much of the surplus, if any arising in the salary and expense fund as may be necessary to reimburse the Treasury of the United States for payments made on account of such fund in any prior year." Bankruptcy Act § 40c (4), 11 U.S.C. § 68c (4).

of the congressional proceedings preliminary to the enactment of the Referees' Salary Act,[4] explicitly recites that the system was intended to be self-sustaining:

"It is intended that the total amount of fees and allowances to be collected for referees' compensation and for their expenses will approximate, repectively, the total amount of the salaries of the referees in active service and the total amount of their expenditures on a yearly basis. . . . In this way, so far as the Government is concerned the system will be self-sustaining over a period of years as it is at present." [Emphasis supplied.]

AMOUNT OF SALARY

Section 40 of the Act also specifies the manner in which referees' salaries are to be fixed. Until 1947, referees in bankruptcy were compensated under a fee system.[5] The Bankruptcy Act of 1800 contemplated the payment of fees and expenses either out of assets or by petitioning creditors, and required the district court judge to fix the rate of allowances to be made to commissioners in bankruptcy, as they were then known, subject to the right of a creditor to object to any charge.[6] The Act of 1841 required district judges to fix tables of fees and charges for the services of the commissioners in bankruptcy.[7] By the Act of 1867, the fees of registers in bankruptcy, as they were called, were to be established by the Act and by the General Orders promulgated by the Supreme Court, and such "fees shall be paid to them by the parties for whom the services may be rendered in the course of such proceedings authorized by this Act."[8] The courts have generally explained the repeal of the Act of 1867 as having come primarily in response to its 'vicious fee system'.[9] The historical development and the legislative tenacity of the free system are demonstrated in the following language from a pre-Chandler Act congressional report.

"(a) Pecuniary interest of referees:

"It is contended that the referee in the exercise of his judicial functions, is called upon to decide issues in the outcome of which he has a financial interest. Such a condition, it is argued, is unsound in principle and should be avoided. . . .

". . . .

"[THE] fee basis of compensation has been a part of every bankruptcy law enacted by Congress. The periods of operations of the Acts of 1800 and 1841 were much too brief to have afforded any test of experience to warrant a conclusion as to the workability of that system. It may be stated, however, as a fact that we have found no record of any complaint. The act of 1867, despite the ameliorating amendments of 1874, was under persistent attack and was repealed in 1878. It is asserted that one of the reasons was the excessive burden of costs incident to bankruptcy proceedings. It should be noted, however that *the dissatisfaction with the system*, as applied to the registers, *was due* not to any abuse on their part, but rather *to the unsound scheme of making the charges.* Since *the fees were to be paid by the parties 'for whom the services may be rendered,'* the creditor or other party seeking in the proceeding to test his legal rights was subjected to the burden of paying the costs incident thereto. Furthermore, *the fees were based upon*

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[4] H.R. 1037, 79th Cong., 1st Sess. at 5–6 (1945).

[5] The true import of the Referees' Salary Act of 1946 (effective July 1, 1947) was best expressed by Judge Alfred P. Murrah, then the Chief Judge of the Court of Appeals for the Tenth Circuit and now Director of the Federal Judicial Center:

"The act of 1946 is probably the most significant in the long history of the bankruptcy law. The tenure of the referee was extended to six years and was made secure against removal without cause. But, more important, came *the law which emancipated the referee from the hated fee system*, provided a salary to be fixed by the Judicial Conference within prescribed limits, and retirement comparable to Civil Service. The question now before the Judicial Conference of the United States is whether the Conference shall recommend legislation whereby referees in bankruptcy shall be raised to the rank and dignity which the dignity of their office justly entitled them." (*Emphasis supplied.*)

[6] Sections 46 and 47 of the Bankruptcy Act of 1800; enacted 2 Stat. 19 (1800), and repealed, 2 Stat. 248 (December 19, 1803).

[7] Section 6 of the Bankruptcy Act of 1841; enacted, 5 Stat. 440 (1841), and repealed, 5 Stat. 614 (March 3, 1843).

[8] The quoted language is from section 4 of the Bankruptcy Act of 1867. *See also* §§ 5, 10 and 47 of the Act of 1867. The Bankruptcy Act of 1867 was passed March 2, 1867, 14 Stat. 517 (1867). It was amended frequently over the years, most substantially by 18 Stat. 178 (1874), until its repeal by the Act of June 7, 1878, 20 Stat. 99 (1878).

[9] E.g., *In re* Wells, 114 Fed. 22, 225, 8 Am. Bankr. R. 75 (W.D. Mo. 1902). *See also In re* Oakland Lumber Co., 174 Fed. 634, 23 Am. Bankr. R. 181 (2nd Cir. 1909).

the quantum of service rendered. The litigant paid a fixed fee for every step taken. . . .

[THE] *fee schedule . . . placed the heaviest burden upon those who could least bear it. . . . The amendment of 1874,* which cut the fee charges in half *did not remove the irritation and dissatisfaction* constantly arising, *whenever litigants were obliged to pay fee after fee as the litigation progressed.*" [10]

LONGTIME EFFORT

Efforts to convert the referees' compensation to a salary basis began in 1881 under the auspices of the Boston Merchants Association. Later, in 1889 Colonel J. A. Torrey of St. Louis drafted a bill patterned after the Lowell Bill, which was introduced in Congress in 1889. The Torrey Bill was enacted in 1898, but its salary provisions were deleted because they were deemed unworkable, and the fee system was retained. Under the Bankruptcy Act of 1898 the basis upon which referees' fees were to be computed was altered, so as to make them payable out of the assets of the estate rather than by the parties 'for whom the services were rendered'. Rather than remaining dependent upon the quantum of service devoted, the *fees of referees in bankruptcy therefore became contingent upon the results of their deliberations.* Curiously enough this change was viewed with approval by the Congress, and was a principal reason why a salary approach to the compensation of referees was not enacted along with the sweeping reforms of the Chandler Act of 1938.[11] Upon more careful consideration it should be obvious that to compensate a judicial officer on the basis of time spent, pleadings received and hearings held is far less likely to influence his judgment than to compensate him on the basis of the results of his judicial deliberations. Furthermore, upon a yet more critical consideration of the Referees' Salary Act, it can be seen that the fragile accomplishment of that landmark legislation lay in the fact that the eyes of interested parties were obscured from the continuing reality that they were bearing the cost of the referees' compensation *collectively* out of the assets of the estate, rather than individually on a hearing-by-hearing or pleading-by-pleading basis as before. Of course, the Referees' Salary Act did minimize the immediacy of the old fee system as well as its financial excesses by limiting compensation to a fixed salary payable out of the fees paid by each bankrupt estate into the referees' salary fund.

DEEMED UNWORKABLE

Among the more important reasons that Congress failed to enact the salary provisions of the Torrey Bill in 1898 was the fact that those salary provisions were deemed unworkable, because the scattered and varying densities of population made it difficult to establish a system of full-time referees.[12] Another obstacle to congressional passage of the salary provisions was the fear of political log-rolling, as expressed by the Congress itself—

> "To subject this important office to the risk of political log-rolling would strike at the very foundations to the bankruptcy law. . . ." [13]

In fact, in 1936 Congress seemed so satisfied with the referees' fee system that it was moved to observe:

> "The present fee system has been in operation for over thirty years and, it would seem, has given entire satisfaction. In his report, the Solicitor General acknowledges that referees have not been '*consciously* influenced' by their pecuniary interest in the performance of their 'judicial or administrative duties' (page 30). It may be of interest to observe that in the reported cases, there is not a single instance of review of a referee's decision on the ground that it was influenced by his monetary interest." [14] (*Emphasis supplied.*)

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[10] (*Emphasis supplied.*) Analysis of H.R. 12889, 74th Cong., 2d Sess. at 150–53 (1936).

[11] However demeaning to those involved, it is conceivable that there be latent concern among litigants that judicial officer might be tempted to linger too long over his deliberations, when compensation is made to depend on "the quantum of service rendered." But it is doubtful that such concern, even if warranted, would threaten public confidence in the judicial system to the same extent as where compensation is made to depend upon the outcome of those deliberations. At least in the former approach to judicial compensation there is no conceivable financial incentive to color or alter one's judgment, but only to delay its pronouncement.

[12] *See* Chandler, "The Outlook Under the New Referee," 21 Ref. J. 9, 12 (1946).

[13] Analysis of H.R. 12889, 74th Cong., 2d Sess. at 150 (1936).

[14] Id. (*Emphasis supplied.*)

It is no exaggeration to state that those words are as true today in respect to the present 'fee system' as they were of the system in force in 1936, except that the present system has only been in operation for approximately twenty-three years. The real question is whether the Congress and the federal courts of today would subscribe to any such bland appraisal of a judicial system funded exclusively by fees collected from litigants, on the basis, at least in part, of the outcome of the litigation.[15]

Among the several practical obstacles to which reference was had by Congress in its deliberations over the Chandler Act, and which, it believed, mitigated against tampering with the fee system, were:

> "[The] method of appointment of referees, the number to be appointed, their employment on a full-time basis, the salary to be fixed, how to be fixed, whether uniform or graded, and if graded, the basis upon which to do so, and other like details. A mere recital of these subjects indicates the many difficulties involved."[16]

The problems which prompted the Congress to stop short of legislating a salary system in 1936 remain largely unsolved to this day. The Chandler Act merely succeeded in avoiding those problems. The Referees' Salary Act of 1946 succeeded in "passing the buck" to the newly created Administrative Office of the United States Courts and to the Judicial Conference of the United States. It is in those quarters that these difficult problems which yet confront our bankruptcy court system are lodged.

APPOINTMENT OF REFEREES

The Chandler Act of 1938 continued the earlier practice of empowering the district court judges to appoint referees in bankruptcy. The term of office under the Chandler Act was for two years, and the district judge could appoint as many referees within his district as the business of the district required, although he was supposed to limit their number with a view to creating as many full-time positions as possible. The Referees' Salary Act increased the term of office for referees in bankruptcy from two to six years, the grounds for removal from office were greatly restricted and numerous important amendments were made to adjust the method of compensating referees.[17]

Such troublesome questions as the number, territory and salaries of referees were left to the Judicial Conference of the United States, acting on the advice of the councils of the circuits and the Director of the Administrative Office of the United States Courts. Section 40c. of the Act is commonly thought to have abolished the fee system by legislating that referees were to receive salaries, fixed by the Judicial Conference at rates not in excess of a congressionally prescribed maximum. Section 40 of the Act provides broad outlines for fixing the amount of the salary to be allowed each individual referee:

> "[CONSIDERATION] shall be given to the average number and the types of, and the average amount of gross assets realized from, cases closed and pending in the territory which the referee is to serve, during the last preceding

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[15] It should not for a moment be supposed that the potential abuses of the present system escape attention, or are discounted by all as unthinkable.

"Those who operate the bankruptcy machinery have a personal stake in shooting down the secured creditor who claims more than his pro rata share of the assets." Coogan, Hagen & Vagts, Bender's U.C.C. Service. Secured Transactions § 1.04[5] [d], at 13 (1969 Ed).

[16] Id.

[17] As originally drafted the Referees' Salary Act (originally H.R. 4160) required *reappointment* of the referee at the end of a term of office except for "incompetency, misconduct or neglect of duty," the same clauses which the present law requires for *removal* of a referee from office. This provision was deleted from the final version by the Senate. The Senate Judiciary Committee seemed justly proud of H.R. 4160, in its original form, as evidenced by the following language from the report:

> "[THE] increase in the length of the term, together with the provisions on reappointment and removal, should go far toward assuring a competent referee of continuity in office. . . ." S. Rep. No. 959, 79th Cong., 2d Sess. (1946); *see also* Collier, Bankruptcy ¶ 34.01, at 1345, n. 16 (14th Ed. 1969).

The Judicial Conference strongly favored the inclusion of explicit provisions for the protection of the tenure of referees. However, as has been observed by the then Director of the Administrative Office of U.S. Courts:

> "Although the bill went through the House of Representatives in that form and . . . was recommended in those terms by the Judiciary Committee of the Senate, the provision was eliminated on the floor of the Senate: also a provison that before a referee in bankruptcy should be removed during his term on account of misconduct, he should be entitled to a hearing before the judicial council of the circuit. There can be no question that the reason was the opinion of senators who supported the amendments, that, after all, the untrammeled power of the judge in reference to appointment and removal should not be impaired."

period of ten years, and to such other factors as may be material."[18] (*Emphasis supplied.*)

In considering the raising or lowering of the salary of a referee in bankruptcy, the Judicial Conference is to determine whether there has been—

"[a] material increase or decrease in the volume of business or other change in the factors which may be considered material in fixing salaries. . . ."[19]

Among the factors which the Director of the Administrative Office of United States Courts has deemed material in surveys preparatory to recommending salary changes for referees in bankruptcy are: (a) the number and types of cases closed and pending in the referee's territory; (b) the contributions of the referees' office to the Referees' Salary and Expense Fund; (c) the size of the territory and the number and distances to places of holding court within the referee's territory; (d) the number and frequency of unusual and difficult cases pending before the referee. Such criteria are clearly consistent with the plainly stated intention of Congress that the bankruptcy system, so far as the Government is concerned, is to be self-sustaining.[20] The issue is not whether the Judicial Conference and the Administrative Office of the United States Courts have well and truly met their responsibilities under Section 40 of the Bankruptcy Act. *Instead, the issue today is whether the objective of a financially self-sustaining bankruptcy court system is consistent with the judicial function and with the duties incumbent on all members of the judiciary,* including referees in bankruptcy. We are reminded that the proper administration of justice requires of the court not only actual impartiality but also the appearance of impartiality.[21] Surely then the court system within which judicial officers are required to function must not itself contribute either actually or apparently to impressions of partiality. I fear that however worthy and devoted the judges and referees of the court of bankruptcy may be, the appearance of partiality which the present fee system offers to litigants and to the bar weighs heavily against the desired image of impartiality in the bankruptcy court.

STILL COMMISSION BASIS

Reasonable familiarity with the salary system for referees in bankruptcy leaves little room for doubt that referees in bankruptcy are yet compensated on what is tantamount to a commission basis. For instance, in the event that the number, complexity and 'asset' volume of cases handled in a particular referee's area do not meet the standards set by the Administrative Office for an average full-time referee's caseload, the referee may not be authorized to receive the maximum salary for a full-time referee.[22] His salary will be fixed at some level substantially below that at which other full-time referees are compensated. Such an approach to the fixing of the salaries of federal judicial officers is wholly contrary to the standards applied in determining salaries of other members of the federal judiciary. Nobody deems it relevant, for salary purposes, how many or how large are the cases before a United States district judge in Utah, as compared to a district judge in the Southern District of New York. Both are expected to be full-time federal judges. To the extent a lighter case load permits a judge to do so, he is expected to devote a greater amount of his time and energies to each case which does come before him. The processing of cases in the federal courts, including bankruptcy cases, should not be treated as though the judicial system is analogous to an assembly line system, where labor is compensable on a piecework basis.[23] This piecework approach to the compensation of referees in bankruptcy is also a carryover from the days of the old fee system. In those days the referee was directly compensated on a piecework basis, computed on the numerical and dollar 'asset' volume of the cases processed. Despite all appearances to the contrary, the present salary system has done little more than establish a maximum beyond

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[18] Bankruptcy Act § 40a., 11 U.S.C. §68a.

[19] Id., at § 40b., 11 U.S.C. § 68b.

[20] *See* p. 2, supra.

[21] *Texaco* v. *Chandler,* 354 F. 2d 655, 657 (10th Cir. 1965), *cert. denied,* 383 U.S. 936 (1966).

[22] There are several full-time referees in bankruptcy who receive a lower salary than the maximum approved by the Judicial Conference. Their number has been greatly reduced in recent years because of the fact that until recently overall salary increases have lagged far behind increases in the cost of living.

[23] As inappropriate and questionable a practice as it is, the "assembly line system" or "cafeteria" approach seems to have been consciously adopted by the Administrative Office as the only feasible means of coping with the needs of the bankruptcy courts within the rigid congressional guidelines imposed by the Referees Salary Act. Chandler, supra, 21 Ref. J. at 16.

which the fee compensation of a referee in bankruptcy cannot benefit him personally and immediately. It has done nothing whatsoever to alter the objectionable fact that referees are yet compensated on the basis of the aggregate numerical and asset volume of the cases they process, which dollar volume, to a very real extent, may turn upon the results of the referees' deliberations.

COMMISSION STANDARDS

Since the Congress did not squarely confront the substantial problems involved in completely abolishing the referees' fee system in 1946, such provisions as Section 40c. whereby the responsibility for adjusting the compensation of referees has been passed to the Administrative Office and the Judicial Conference, continue to require the application by these authorities of a commission-type standard for fixing the maximum salary level of referees as a group within the legislative maximum, as well as for stratifying salaries among individual referees within the administrative maximum thus established.[24] So long as the applicable administrative standards render case load and asset volume of cases pertinent considerations,[25] and so long as the system is to be self-sustaining, it will continue to be an illusion to suppose that the bankruptcy courts have abandoned the old fee system; which, it is submitted, would find virtually no support in this day and age, either legislative or judicial, once exposed for what it is.

It is probable that the total abolition of all aspects of the fee system cannot be accomplished without congressional action. However, two very important steps in that direction have been taken recently by the Judicial Conference of the United States, as the result of recommendations by the Bankruptcy Committee, supported by the Honorable Royal E. Jackson, Chief of the Bankruptcy Division of the Administrative Office of United States Courts. At its March 1969 meeting the Judicial Conference of the United States expressed its agreement with the view of the Bankruptcy Committee, chaired by Judge Edward Weinfeld, Southern District of New York, that the principle of a self-supporting bankruptcy system is outdated and unfeasible.[26]

The Judicial Conference also approved a statement of policy that:

> "[THE] legal limitation imposed in the Bankruptcy Act should be removed and that the concept of the Referee's [sic] Salary and Expense Fund should be abandoned." [27]

Later, Judge Weinfeld appointed a special subcommittee to study the criteria and method of fixing salaries of full-time referees in bankruptcy. On the basis of the subcommittee's report the Bankruptcy Committee recommended, and the Judicial Conference approved, a statement of policy that all full-time referees should be paid at the same rate, and that the present criteria should be eliminated from the Bankruptcy Act.[28] In so doing, the Judicial Conference, and especially the Bankruptcy Committee and the Bankruptcy Division of the Administrative Office of U.S. Courts, have made a very significant contribution to the improvement of judicial administration, by removing at least the more apparent and immediate ill effects of indirectly adjusting judicial salaries on the basis of the

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[24] A recent stratification of referees' salaries placed six referees in bankruptcy in a \$25,000 salary bracket and most other full-time referees at \$30,000. However, the present law, amending Section 40a of the Act, fixed the maximum salary for referees in bankruptcy at \$36,000. No referee in the nation is now receiving, nor can any now receive, compensation in excess of \$30,000 by reason of the continuing implementation of the commission-basis approach to compensating referees. In other words, the Director of the Administrative Office recommended and the Judicial Conference agreed that referees should receive a maximum of \$30,000 despite the fact that both the Presidential Salary Commission and the President of the United States had fixed the maximum at \$36,000.

[25] It is submitted that such considerations are far more appropriate for determining *ab initio* the need for a full-time referee position, rather than for determining on an individual basis how much to pay a referee who is required to devote all of his time to his office, regardless of how many cases or dollars he deals with in the conduct of his office. No full-time referee who is compensated at less than the maximum salary allowable is authorized to absent himself or to engage to a proportionate extent in private law practice as a means of supplementing his income.

[26] The Judicial Conference was of the view that the filing fees required of bankrupts, as well as the assessments on assets recovered in these proceedings, represented an inordinate burden on debtors and creditors. Since bankruptcy filing fees, despite the fact they must be born by insolvent debtors, are the highest of any filing fees in the federal courts, the position of the Judicial Conference seems hard to dispute. For a very interesting treatment of the entire subject, *see* Shaeffer, "Proceeding in Bankruptcy in Forma Pauperis," 69 Colum. L. Rev. 1203 (1969); *see also Jeffreys* v. *Jeffreys*, 58 Misc. 2d 1045, 206 N.Y.S. 2d 74 (Sup. Ct. Kings Cty 1968), *comment* 29 Md. L. Rev. 406 (1969).

[27] Report of Proceedings of Judicial Conference of the U.S., Mar. 13–14, 1969, at 24 (Adm. Off. U.S. Courts 1969).

[28] Report of Proceedings of Judicial Conference of U.S., Oct. 31–Nov. 1, 1969, at 76 (Adm. Off. U.S. Courts 1969).

outcome of litigation. The judiciary has denounced thereby the blessedness of the fee that binds in bankruptcy. It now remains, as it has since 1800 for Congress to confront the hard decisions which thus far have been nimbly eluded.[29]

Appendix E

Presidential Salary Recommendations

The 'Salary Commission' recommendations for circuit and district court judges' salaries emerged from the White House less unscathed than did most other judicial salary recommendations. At the upper level, the salary recommendations for Supreme Court Justices was reduced by $5,000 or about eight percent below the level recommended by the 'Salary Commission.' At the lower level, the 'Salary Commission' recommendations for bankruptcy judges and commissioners of the court of claims were reduced by $4,000 or ten percent, by the President. In the intermediate range, district judges' salaries were reduced by $7,500 or sixteen percent, and the salaries of judges of the courts of appeals were reduced by $7,500 or fifteen percent below the levels recommended by the 'Salary Commission.' It is not within our knowledge why the President deemed it advisable to reduce the salary recommendations for circuit and district court judges more substantially than those of either Supreme Court Justices or referees in bankruptcy. Rather, for referees in bankruptcy one critically important fact remains—*referees in bankruptcy finally emerged with the least substantial salary increase of any federal judicial officer in relation to the recommendations of the 'Salary Commission.'*

The gross effect of combined Presidential and Judicial Conference reductions was that the maximum salary increase for referees recommended by the 'Salary Commission' was severely slashed by $10.000 per year or by about sixty per cent. The net salary increase for referees in bankruptcy, therefore, amounted to $7,500, as compared to $20,000 for Supreme Court Justices. $9,500 for circuit court judges and $10,000 for district judges. Referees in bankruptcy, following relatively favorable consideration by the 'Salary Commission,' the President and the Congress, *were finally left with the smallest increase of any federal judicial officer, even though the Salary Commission recommended for them one of the largest increases.*

Appendix F

The 1968 Salary Commission Report

The 'Salary Commission' labored under a gross misunderstanding as to the true nature of the office of referee in bankruptcy—

> "The Referees in Bankruptcy *recommend decisions on both law and facts to the Judge of the District Court, who then renders the Court's Decision.*" [1]

Of course, the actual fact is that bankruptcy judges, except in extremely rare instances prescribe by statute, hear and decide all issues of fact and law and enter final orders thereon.[2] Despite that misunderstanding, however, the

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[29] With the recent enactment of Senate Joint Resolution 88, it may be that Congress will be confronted directly with this problem in the very near future. Senate Joint Resolution 88 provides for the creation and funding of a nine member commission to study the entire bankruptcy system, and requires that the report of the commission be made within two years.

[1] (Emphasis supplied.) Report of the Commission on Executive, Legislative, and Judicial Salaries, 15 (December, 1968).

[2] *See* Bankruptcy Act §§ 2 and 38, 11 U.S.C. §§ 11 and 16. *See also* n. 4 infra.

No doubt the "Salary Commission" was misled by some of the awkward terminology still employed in the Bankruptcy Act, particularly the title "referee" and the term "review." *See* Herzog, "The Referee in Bankruptcy: A Judge In Search of A Name," 53 J. Am. Jud. Soc'y 202 (1969); 44 Ref. J. 39 (1970).

A distinguished jurist and dedicated architect of improvements in federal judicial administration, Judge Alfred P. Murrah, Director of the Federal Judicial Center, recently observed—

> "It is my judgment that as the [bankruptcy] study progresses the [S.J. 88] Commission and the country will learn that it has a resource it did not realize it possesses in the knowledge, industry and loyalty of its crops of referees. *It is also my prediction that when the recommendations of the Commission become law the misunderstood term "referee in bankruptcy" will be a thing of the past and that the referees will be translated truly into bankruptcy judges with appropriate status, adequate powers and sufficient supporting personnel to enable them properly to discharge in the public interest the heavy responsibilities entrusted to them.*" (Emphasis supplied.) Address by Judge Alfred P. Murrah, Director of the Federal Judicial Center, 44th Annual Meeting of the National Conference of Referees in Bankruptcy, September 2, 1970.

Of course, the Rules of Bankruptcy Procedure which have been in effect since October 1, 1973 have brought a very substantial improvement in the practice and procedures of the bankruptcy court and in the status of the office of bankruptcy judge.

'Salary Commission' recommended the same maximum salary for bankruptcy judges as for commissioners of the court of claims, of whose office the 'Commission' erroneously observed:

> "*The Commissioners of the Court of Claims act as trial Judges for the Court.* After proceedings before them are completed, the Commissioners prepare findings of fact and conclusions of law which are then submitted to the parties and the Court. If there is no appeal by the parties to the case, the Court, after review, will normally adopt the Commissioner's decision as its own."[3]

The fact is that Referees in Bankruptcy act as the trial judges of the Bankruptcy Court,[4] whereas Commissioners act as referees of the Court of Claims.[5]

Appendix G

Federal System

Highest Court:	
Supreme Court:	
Chief Justice	$62,500
Associate Justices	60,000
Intermediate Appellate Courts:	
U.S. Court of Appeals	42,500
General Trial Courts:	
U.S. District Court	40,000
Territorial Courts (Canal Zone, Virgin Islands, Puerto Rico and Guam)	40,000
Limited and Special Courts:	
Court of Claims	42,500
Court of Military Appeals	42,500
Court of Customs and Patent Appeals	42,500
Tax Court	40,000
Customs Court	40,000
U.S. Magistrates (full-time)	30,000
U.S. Referees in Bankruptcy (full-time)	31,650
Court Administrator:	
Dir. of Adm. Office of the Courts	40,000
Circuit Executives	36,000
Clerks of Court:	
Clerks, Ct. of Appeals	30,000
Clerks, Dist. Cts. (Large)	30.000
Clerks, Dist. Cts. (Medium)	27,000
Clerks, Dist. Cts. (Small)	24,000
Clerks, Dist. Cts. (Terr.)	20,000
Clerks, Special Cts	30,000

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[3] (Emphasis supplied.) *See* n. 1 supra.

[4] "Under the Chandler Act, passed in 1938, the referee is the judge of the court of bankruptcy." 20 Ref. J. 105 (1946) (Statement of Senator James W. Huffman of Ohio, floor manager of H.R. 4160—Referees' Salary Act of 1946).

"It is now firmly settled that upon general reference the referee acts as a court of bankruptcy, except as to those matters which the Act or the General Orders reserve to the judge alone." 2 Collier, Bankruptcy ¶ 28.02, n. 1 (1969 ed.).

"[A]fter a general reference the referee possesses complete jurisdiction of the proceedings, including power to extend, for cause shown, the time for petitions to review and to reexamine and vacate his decisions whenever and as long as determinations of the courts are open to such action. The practice before the referee should not differ from that before the judge of the court of bankruptcy and, apart from direct review within the limitation of § 39(c), the orders of the referee are entitled to the same presumption of validity, conclusiveness and recognition in the court of bankruptcy or other courts." 1 Collier, Bankruptcy ¶ 1.09 (1969 ed.) (footnotes omitted).

[5] The court claims may refer matters to commissioners, but the report, when made, must be considered by the court, which must render judgment. Intermingled Cotton Cases, 92 U.S. 651, 2 Otto 651, 23 L.Ed. 756 (1876).

> "(a) Parties to any suit in the Court of Claims may appear before a commissioner in person or by attorney, produce evidence and examine witnesses. In accordance with rules and orders of the court, commissioners shall fix times for trials, administer oaths or affirmations to and examine witnesses, receive evidence and report findings of fact and, when directed by the court, their recommendations for conclusions of law in cases assigned to them. Hearings shall, if convenient, be held in the counties where the witnesses reside.
>
> "(b) The rules of the court shall provide for the filing in court of the commissioner's report of facts and recommendations for conclusions of law, and for opportunity for the parties to file exceptions thereto, and a hearing thereon before the court within a reasonable time. This section shall not prevent the court from passing upon all qustions and findings regardless of whether exceptions were taken before a commissioner." 28 U.S.C. § 2503.

BENEFITS

Hospitalization.—Covered by government health programs, premiums are shared. Life insurance available.

Vacation.—Not to exceed one month.

Holidays.—Generally correspond to those observed in the place where the court sits.

Expense allowance.—Judge reimbursed for official travel for actual expenses of $40 per day or a per diem of $25. Mileage: 12¢.

RETIREMENT PLANS

Judges Covered.—Any justice or judge of the United States appointed to hold office during good behavior. Judges of U.S. Court of Military Appeals and U.S. Tax Court not included.

Age and Service Requirement.—65 after 15 years service, or 70 after 10; justices or judges who retire under these circumstances are eligible for full retirement benefits.

Contribution.—A. None; optional 3% to judicial survivor's annuity fund.

Retirement Benefits.—Salary of the office from which retired.

Death Benefits.—Widow of a justice or judge may receive an annuity of up to 37.5% of his average final salary plus up to $360 for dependent children. Such annuity depends upon the justice or judge contributing 3% of his salary to the judicial survivor's annuity fund.

Disability Benefits.—Any age with 10 years service, full current salary; if less than 10 years service, 50% of that amount. Judge of territorial court with 16 years service receives full salary at the time of relinquishment of office, if he has served between 10 and 16 years, he receives the proportion of such salary which the number of his total years service bears to 16. Such annuity commences at age 65.

Service After Retirement.—Judge appointed for life tenure retire only from active service and retain their office and may be assigned to judicial service by the administrative head of the court.

Citation U.S.C.A.—Title 28, ch. 17, §§ 371 through 376.

APPENDIX H

JUDICIAL SALARIES IN APPELLATE AND TRIAL COURTS

The salaries reported here are 1974 salaries. The 1st figure in the "Change,, column refers to the changes from 1968 to 1974 as compiled from the 1974 and the 1968 American Judicature Society salary survey data, the 2d figure is derived by subtracting the 1972 American Judicature Society salary survey data from the 1974 figures.

Supplemental salaries at the general trial court level are rapidly disappearing so supplemental data has been separated out in the table below. For example, read Alabama as follows: General trial court State-paid salary, $25,000; change in State-paid salary from 1968 to 1974, $10,000; change in State-paid salary from 1972 to 1974, $7,000; maximum salary paid to a general trial court judge (that is, State-paid salary plus the highest local supplement), $32,500; change in maximum salary from 1968 to 1974, $13,500; change in maximum salary from 1972 to 1974, $8,000. These maximum salaries are reported in parentheses.

The Supreme Court salaries refer to salaries paid to Associate Justices, likewise general trial court salaries refer to salaries paid to regular judge

State	Supreme court	Change 1968–74	Change 1972–74	General trial court	Change 1968–74	Change 1972–74
Alabama	$33, 500	$14, 000	$11, 000	$25, 000 (32, 500)	$10, 000 (13, 500)	$7, 000 (8, 000)
Alaska	44, 000	18, 000	8, 000	40, 000	17, 000	7, 000
Arizona	37, 000	13, 500	5, 000	33, 000	11, 500	5, 000
Arkansas	27, 500	7, 500	3, 900	25, 000	7, 000	4, 600
California	51, 615	19, 615	5, 032	40. 322	15, 322	3, 929
Colorado	35, 000	13, 000	7, 500	28, 000	10, 000	5, 500
Connecticut	36, 000	7, 000	0	34, 500	7, 000	0
Delaware	42, 000	17. 500	8, 000	39, 000	15, 500	8, 000
Florida	40, 000	6, 000	4, 000	36, 000	12, 000	4, 000
Georgia	40, 000	13, 500	7, 500	32, 500 (44, 600)	14, 500 (12, 600)	7, 700 (5, 800)
Hawaii	32, 670	5, 670	0	30, 250	5, 250	0
Idaho	30, 000	10, 000	5, 000	27, 000	10, 500	5, 000
Illinois	[1] 42, 500	5, 000	2, 500	[1] 30, 000 (37, 500)	6, 500 (5, 000)	2, 500 (2, 500)
Indiana	29, 500	7, 000	0	26, 500	4, 500	0
Iowa	33, 000	11, 000	8, 000	29, 000	10, 000	7, 500
Kansas	32, 500	11, 000	7, 707	27, 500 (30, 032)	10, 000 (12, 532)	6, 927 (7, 059)

APPENDIX H—Continued

JUDICIAL SALARIES IN APPELLATE AND TRIAL COURTS—Continued

State	Supreme court	Change 1968–74	Change 1972–74	General trial court	Change 1968–74	Change 1972–74
Kentucky	31, 500	5, 500	2, 500	26, 000	8, 500	2, 500
Louisiana	37, 500	12, 500	0	20, 500	7, 300	0
				(38, 500)	(15, 800)	(4, 500)
Maine	26, 000	6, 000	2, 000	25, 500	6, 000	2, 000
Maryland	42, 800	10, 300	2, 800	38, 000	7, 500	2, 500
Massachusetts	40, 788	11, 068	6, 988	36, 203	9, 803	6, 203
Michigan	[1] 42, 000	7, 000	0	26, 500	6, 500	2, 500
				(41, 759)	(11, 759)	(6, 759)
Minnesota	36, 500	10, 500	4, 000	33, 500	10, 000	3, 000
Mississippi	34, 000	15, 000	8, 000	30, 000	14, 000	8, 000
Missouri	31, 500	5, 000	0	28, 000	5, 000	0
Montana	27, 000	10, 000	4, 500	25, 000	10, 000	6, 000
Nebraska	35, 000	14, 500	4, 500	32, 500	14, 500	5, 000
				(34, 000)	(14, 500)	(5, 000)
Nevada	35, 000	13, 000	7, 000	30, 000	10, 500	6, 000
New Hampshire	33, 800	10, 920	6, 300	33, 696	12, 896	7, 896
New Jersey	48, 000	17, 000	3, 000	40, 000	13, 000	3, 000
New Mexico	29, 500	8, 500	1, 338	27, 000	8, 500	1, 567
New York	63, 143	23, 643	13, 478	[2] 48, 998	11, 998	5, 681
North Carolina	38, 000	11, 000	5, 000	30, 500	10, 500	5, 000
North Dakota	28, 000	10, 000	6, 000	26, 000	10, 000	6, 000
Ohio	40, 000	10, 000	10, 000	[2] 34, 000	8, 000	8, 000
Oklahoma	30, 000	7, 500	5, 000	25, 000	8, 000	4, 500
Oregon	32, 000	8, 500	5, 000	29, 000	8, 000	4, 000
Pennsylvania	50, 000	12, 500	10, 000	40, 000	10, 000	7, 500
Rhode Island	33, 000	8, 000	3, 000	31, 000	10, 000	3, 000
South Carolina	36, 380	11, 880	6, 380	36, 380	11, 880	6, 380
South Dakota	28, 000	7, 500	4, 000	26, 000	7, 500	4, 000
Tennessee	38, 400	18, 400	14, 400	32, 000	17, 000	14, 500
Texas	40, 000	13, 000	7, 000	25, 000	7, 000	3, 000
				(38, 000)	(12, 000)	(4, 000)
Utah	24, 000	7, 500	1, 000	22, 000	8, 000	1, 000
Vermont	29, 900	8, 900	4, 900	25, 800	6, 800	3, 800
Virginia	40, 300	17, 500	7, 750	29, 900	12, 400	5, 750
				(40, 200)	(3)	(3)
Washington	34, 825	7, 326	1, 825	28, 500	6, 000	1, 500
West Virginia	32, 500	10, 000	5, 000	28, 500	13, 000	2, 125
Wisconsin	30, 732	15, 732	11, 732	25, 044	5, 044	4, 044
				(34, 500)	(9, 500)	(6, 500)
Wyoming	30, 000	13, 500	7, 500	27, 500	12, 500	6, 500
District of Columbia	38, 250	13, 750	0	36, 000	12, 500	0
Federal system	60, 000	20, 500	0	40, 000	10, 000	0
Commonwealth of Puerto Rico	32, 000	10, 000	5, 000	26, 000	8, 000	3, 100
National average	36, 117	11, 170	5, 801	32, 485	10, 400	4, 953

[1] This statistic may change in November 1974.
[2] Supplemental salary not separated out due to incomplete data.
[3] Unknown.

APPENDIX I

On a number of occasions, beginning in March of 1969, the Judicial Conference has taken the position that the maximum salary of magistrates should be on a parity with the maximum salary paid to bankruptcy judges. *See, e.g.*, Report of Proceedings of Judicial Conference of U.S., March 13–14, 1969, at 31 (Adm. Off. U.S. Courts 1969); Report of Proceedings of Judicial Conference of U.S., October 28–29, 1971, at 66 (Adm. Off. U.S. Courts 1971). On October 28, 1971, the Judicial Conference of the United States prescribed the following maximum salaries:

> "....
>
> (2) Full-time Referee in Bankruptcy 75 to 80% of a district judge's salary.
>
> (3) Full-time United States Magistrate 75 to 80% of a district judge's salary."[1]
>
> ....
>
> The Conference then approved the following as the maximum salaries that may be paid at this time based on this structure . . .
>
> Full-time referee in bankruptcy, 32,000.
>
> Full-time U.S. magistrate, 32,000.
>
> ...."[2]

[1] Report of Proceedings of Judicial Conference of U.S., Oct. 28–29, 1971, at 65 (Adm. Off. U.S. Courts 1971).
[2] Id. at 65–66.

The Judicial Conference thereupon rejected the recommendations of its own Bankruptcy Committee and of the Director of the Administrative Office of U.S. Courts, both of which had recommended approval of an immediate increase in the salaries of all full-time referees in bankruptcy as permitted generally by Section 3(d) of the Economic Stabilization Act of 1971.[3]

The Judicial Conference ". . . took the position that the referees' salaries should be increased by the 5.5 percent formula but *only at such time as the salaries of United States magistrates are brought to a comparable position with the salaries of full-time referees in bankruptcy.*" [4]

Judge MORTON. Now, to fully identify those who are here to testify, Judge Cyr, whom I have just mentioned, from Bangor, Maine, is on my right. He is a vice president of our Conference of Bankruptcy Judges. On my left is Judge Joe Lee of Lexington, Ky. He is the immediate past president of our conference. And we also have with us Daniel R. Cowans of San Jose and San Francisco, Calif., until recently one of our brother judges. And then on the far left we have Judge Joseph Patchan of Cleveland, Ohio, who I am sorry to say will soon join the growing ranks of our departed colleagues.

Mr. Chairman, we want to use this time and opportunity which has been so generously accorded to the best advantage, and we will undertake to convey to you the newest information that we have been able to assemble, and to express to you the current state of our views as to the situation that the bankruptcy judges find themselves in.

I will try to avoid repetition, unnecessary repetition, at least of parts of the formal statement which has been admitted in the record.

I think that the purpose of the bill, S. 582, that you have just expressed, could not be better stated. I think it might be well at the outset to try to bring the committee up to date on what has transpired since that early day in February, I believe it was February 5 of this year, when the bill was introduced.

I believe we reported then our concern that some six bankruptcy judges of demonstrated competence and experience had resigned, and I think we then also indicated a rather ominous set of figures that indicated a continuing rise to an all-time high in bankruptcy litigation, both in the numbers of cases and in the complexity of the cases.

Now, in the 90 days that have elapsed since then, to today, I have to report to you that we have lost, in addition to those judges that have been identified before, some others. One is a very capable and vigorous young judge in Georgia; another an equally promising judge in Michigan; a highly competent and very experienced judge has left the bench in Miami, Fla., where there are literally hundreds of real estate investment trusts in court for relief today. And in Columbus, Ohio, as perhaps the major real estate developer in the Mid-Atlantic and Southern States comes in for chapter XI relief, we are losing another of our most competent and experienced colleagues, Judge John Dilenschneider.

Most recently, Judge Patchan of Cleveland is leaving us very shortly, and he has in hand a letter to the Chairman from Judge Dilenschneider and he also has with him for delivery and filing his own letter. So in the course of this testimony we would like to turn to Judge Patchan at the appropriate time to give you his views from his

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[3] Report of Proceedings of Judicial Conference of U.S., Apr. 6–7, 1972, at 7 (Adm. Off. U.S. Courts 1972).
[4] Id.

own vantage point of the reasons that have compelled him to leave our ranks.

Judge Cowans I need not dwell upon. He is one of the most distinguished figures in bankruptcy law in this country. I need not even catalog his accomplishments. He is a former president of our conference, professor of law in California, member of the National Bankruptcy Commission, and I thought it appropriate to ask him, now that he has left our service, to come before the committee and to give his assessment of the situation from the vantage point that he now occupies.

Now, Mr. Chairman, that is one area of unfortunate development, not unexpected, I may say, that has occurred since February 5.

There has been a second development, and I do not want to burden the record with figures, so I will make this brief. The volume of litigation that has been developing recently bears listening to. In the first 9 months of this current year, total filings of all types of bankruptcies were 148,655. That compares with 136,597 for the same period of last year. The increase is 35.2 percent.

By historical experience, the heaviest filings occur in the last months of the fiscal year. But just at the present rate of increase, it is a certainty that the total filings this year will exceed 260,000, which compares with the previous high of 208,000 in 1967.

Let me point out something that is significant. The business filings, Mr. Chairman, are up 50 percent, while the rise in consumer cases is 31 percent. Now, let us break down the business area. For the first 7 months, and these are the latest figures I was able to get, at this fiscal year compared with the same first 7 months of last year, we have 1,875 Chapter XI filings as compared with 1,162 last year, an increase of 61.4 percent.

Chapter X is the corporate reorganization proceeding; they have increased from 62 to 123, an increase of 95.2 percent. Chapter X is a hitherto seldom used relief from real estate foreclosures which is up 142 this year compared to 74 last year, an increase of 91.9 percent.

Now, in further preparation for this hearing, and in an effort to assemble some data that might be helpful, I endeavored to ascertain some information that would indicate the complexity and the magnitude of some of these business cases. We realize, of course, that the Chapter XI case is the sole responsibility of the bankruptcy judge. The Chapter X case is in a sort of a muddled state. It can, if the district judge so decides, be assigned to the bankruptcy judge under a maximum reference, so in some instances where there has been such a maximum reference, which otherwise stated means the bankruptcy judge has the primary responsibility, I will give you some figures. But I was unable to fiand, and indeed, I am convinced that the figures assembled are not near the actual aggregate amount of the assets of the businesses in Chapter XI today that are under the bankruptcy judges, and thus their responsibility.

The few telephone calls that I was able to make to some colleagues around the country did provide some information that I want to relate to you. I think it is most impressive, most material. But in this connection, if it is possible to have the opportunity to try to develop firm figures of the kind that I am going to refer to, I would cer-

tainly appreciate the opportunity and privilege of submitting those at a later time as an exhibit, Mr. Chairman.

Senator BURDICK. You may.

Judge MORTON. Now, I would just relate three or four of these calls, and then I will defer to questions or to some of my colleagues here.

Judge Richard Stageman is in Iowa. He has the multimillion-dollar Chapter XI case pending of Mid-Iowa Lakes, another in the same category of the same magnitude with thousands of creditors is Investors Equity, and still a third real estate developer is Arrowhead Resorts. He has the rather unique case of the Chapter XI matter of Parsons College which has raised interesting and first-time questions of various kinds.

Now, as Judge Dilenschneider announces today to you his resignation from the bankruptcy bench in Columbus, Ohio, he reports the filing of a Chapter XI case of George Deffet, one of the major real estate developers in the country with multistate operations in Ohio, North and South Carolina, Tennessee, Alabama and Kentucky with scheduled assets of $47 million, liabilities of $38 million. There are 600 creditors, many of whom are major banks geographically scattered across the country. Judge Dilenschneider will be leaving the case, a Chapter XI matter, of American United Inns which operates 26 Ramada Inns with assets of $17 million and liabilities of $13 million.

The cases under Chapter XI in Texas are truly awesome. I could not get all of the figures that I wanted, but let me just allude to one. It is the American Grain and Cattle Co., headquartered at Lubbock, Tex. They own grain elevators scattered throughout the middle tier of States, including my State of Kansas and the chairman's State of North Dakota. Their assets include a complex of elevators in Plainview, Tex., the largest in the world. The aggregate capacity of these grain elevators is 33 million bushels, and the replacement cost has been determined to be $63 million.

In Fort Worth, Tex., Texas Consumer Finance Co. is pending with liabilities of $33 million. And I may add the report that there is enough money on hand generated from operations during the Chapter XI phase to assure at least a 57-percent payout.

And finally, I should mention in Texas the Dallas case of a broker in silver and gold bullion specializing in puts and calls, the Secure Monetary Systems, with assets in excess of $8 million, and with prospects that there will be a 100-percent payout.

Let me move then to the west coast. In San Diego, Judge Katz has pending under Chapter XI the case of U.S. Financial, with liabilities of $350 million, and assets of $275 million. He has also the LeBaron Hotels with liabilities of $30 million and assets of $65 million.

He has under a maximum Chapter X reference the Royal Inns of America with assets of $65 million and liabilities of roughly the same amount.

I move north to Fresno, Calif., and my talk with Judge Eckhart Thompson there. Since January 1 of this year, he has had 61 Chapter XI cases filed, 61 new cases filed. Fourteen of these involve assets in excess of $1 million. One is as high as $20 million.

A short comment and report on New York. The pending Chapter XI

cases there in the southern district only involve assets of companies which total somewhere between $250 and $500 million. REA in that area is one of the major corporations of the country, and its assets are $100 million with 47,000 creditors.

Now, going to the South. In Atlanta, Ga., I just have this one example. What started there as a Chapter XI Proceeding in the case of North American Acceptance Corp., there are 15,000 creditors of the parent corporation, including 12,000 noteholders. The first meeting of creditors had to be held in the Municipal Auditorium of Atlanta, and approximately 3,000 to 4,000 persons attended.

I come closer to home. I talked to Judge David Crawford, of Omaha, Nebr. Among the major Chapter XI cases he is handling is that of *American Beef*, a $113 million corporation with feedlot operations in 4 States, and scheduled debts of $90 million, 8,000 listed creditors, and many many lawyers. At the first meeting of creditors, 86 attorneys announced appearances.

This comment about *American Beef* and I want to do my best to get this across. *American Beef* appears as a single filing in the statistics of the Administrative Office. It was not a single case. It is a framework of cases, and within that framework, Judge Crawford has 260 separate pending adversary proceedings which translates to 260 separate lawsuits, among cattle feeders, sellers of cattle, banks, and other litigants. So, as will be further developed, I hope, in this testimony, when we talk to you of the magnitude of the Chapter XI and Chapter X cases, each case must be recognized as encompassing many, many separate lawsuits.

As I leave the example of *American Beef*, let me say to you that while Judge Crawford has not been on the bench for a very long period of time, 2 or 3 years, I know that when he finishes a hearing in *American Beef* and turns to the case of a false financial statement of consumer bankrupt, John Doe, he will give both his equal and conscientious consideration. So that is the kind of a broad spectrum, Mr. Chairman, that we are dealing with. And with this mounting volume of heavy, heavy litigation, and with the departure from our bench of our experienced people, to which you have to add the normal attrition of at least 12 a year, I fear that we are arriving at, we have arrived at, a situation that really calls for prompt relief.

Senator BURDICK. I would like to ask you a question here at this point, if I may. I do not want to argue about the tremendous amount of work that has to be done in these courts. I realize this. But on the *Iowa Beef* case, I presume when there are 250 smaller or individual complaints that it is very possible that the decision of the one may decide the few?

Judge MORTON. That is very possible in these Chapter XI situations, Mr. Chairman. But again, it does not occur as frequently as we would like. If you have got this particular fellow who has what turns out to be a bogus draft, the representations that were made in connection with that transaction are often different from another similar problem. Then the banks, of course, have their own unique claims of security interests, so while it is certainly true, as you have observed, that there may be a pattern where a decision of one will carry with it the disposition of the others of precisely the same issue——

Senator BURDICK. But they all have to be reviewed to see if they comport with the same decision and the same set of facts and so forth.

Judge MORTON. Yes. That is true.

Senator BURDICK. And that would take a considerable amount of time.

Judge MORTON. And I am sure we all remember that under the new rules when you have an adversary proceeding, the style is just like an ordinary lawsuit within the framework of your Chapter XI. It is John Doe, trustee, versus the XYZ Bank, and it is carried forward with a summons just like any lawsuit.

Senator BURDICK. I wonder if you would have the figures, or perhaps they can be supplied by the Administrative Office as to what the resignations have been for the past 5 years? Do you have them, or I presume you can get them?

Judge MORTON. I will be glad to get them. That would be easily obtainable. Can I ask, does anyone have that at hand? I would rather not guess at it.

Senator BURDICK. Somebody on the committee might ask that question.

Judge MORTON. Yes. I will certainly supply that, if I may.

[The information supplied follows:]

Re: May 1, 1975 Hearing on S. 582 Before Subcommittee on Improvements in Judicial Machinery, Senator Quentin D. Burdick, Chairman.

BANKRUPTCY JUDGES WHO HAVE RESIGNED DURING LAST 5 YEARS[1]

Name and location of court	Date	Professional pursuit following resignation
Hon. Edward J. Houston, Miami, Fla	June 30, 1970	Private practice.
Hon. Charles F. Hamlin, Fresno, Calif	Feb. 15, 1972	State court judgeship.
Hon. Robert W. Ervin, Tallahassee, Fla	June 15, 1972	Private practice.
Hon. Jerrold L. Strasheim, Omaha, Nebr	Sept. 1, 1973	Do.
Hon. William M. Corrigan, St. Louis, Mo	Nov. 16, 1973	State court judgeship.
Hon. Robert P. Fullerton, Denver, Colo	do	Do.
Hon. Murray M. Schwartz, Wilmington, Del	Apr. 30, 1974	Do.
Hon. Daniel R. Cowans, San Jose, Calif	Oct. 5, 1974	Private practice.
Hon. Edward A. Quinnell, Marquette, Mich	Nov. 11, 1974	State court judgeship.
Hon. Stephen J. Covey, Peoria, Ill	Dec. 1, 1974	Do.
Hon. Arthur L. Moller, Houston, Tex	Dec. 31, 1974	Private practice.
Hon. Raymond J. Pellman, Cincinnati, Ohio	do	Do.
Hon. Dudley H. Bowens, Jr., Savannah, Ga	Serving until successor appointed.	
Hon. Joseph Patchan, Cleveland, Ohio	do	
Hon. John J. Dilenschneider, Columbus, Ohio	do	
Hon. James E. Yacos, Miami, Fla	do	

[1] Terminations by reason of death and age retirement not included.

Senator BURDICK. Who is next?

Judge MORTON. Judge Cyr.

Judge CYR. Mr. Chairman, first let me say thank you once again for affording us this opportunity to be heard. An opportunity to be heard is ever appreciated by us.

Before going into the very brief statement which I have prepared, I would like simply to clarify what I think is a rather common misconception about bankruptcy litigation and the bankruptcy caseload, which is that only in major metropolitan areas do these complex and large volume asset cases occur. Unless Bangor, Maine, qualifies as a major metropolitan area, that simply will not withstand analysis. Bangor, I think, counting most of the cows and all of the people would constitute perhaps 100,000 people.

In my own district, I have pending in the neighborhood of 40 arrangements, around eight Chapter XII real estate arrangements, one Chapter X which involves the International Airport handling 70 percent of all of the charter air traffic over the North Atlantic route. I have the only active Chapter XI in the country relating to the operation of a liberal arts college with 450 students. This is typical of the kind of thing that is occurring even in the backwater areas of this country.

In addition, we have a very heavy consumer caseload. As an example of the kind of litigation that arises in that area, for the past 10 years there has been litigation pending involving the question of usury in small loan company claims filed against debtors in Chapter XIII proceedings, and that litigation is no longer—well, it is still pending. My colleague in Portland, Maine, has resigned. He was the one who began with this litigation. It will be left to me. Yesterday afternoon at 5 he entered an order disallowing claims in 500 separate cases. Consumer cases also present not only very important issues, but sometimes extremely complex ones.

That aside for the moment, Mr. Chairman, I would just like to make a few remarks concerning the overall economic context in which the pending proposal arises.

The salaries of bankruptcy judges, like those of judges of other Federal courts, Members of Congress, and top grade Federal executives, have been frozen since March 1969, when the first and last "Salary Commission" action was implemented. Since that time, the Consumer Price Index has risen approximately 48 percent, which has resulted in enormous erosion of the purchasing power of bankruptcy judges' and other salaries of positions subject to the "Postal Revenue and Federal Salary Act of 1967," 2 U.S.C. section 351 et seq.

By way of contrast, Federal employees whose salaries are governed by the general schedule have received 38-percent pay increases since March 1969, in addition to the customary step increases accorded them under the Federal employee grade system, which in and of themselves average 14 percent since March 1969. The end result is that since March 1969, graded Federal employees have received salary increases aggregating more than 50 percent, whereas Members of Congress, judges, and ungraded executive personnel have received none, this despite the fact that the salary levels actually fixed in March 1969 for Members of Congress, judges, and top grade Federal executives were substantially lower than those recommended by the Salary Commission.

During the same 6-year period, the salaries of Federal judges have not kept pace with those of State court judges or with those of private practitioners. According to the U.S. Department of Labor, attorneys' salaries have risen 43.9 percent since 1969; and whereas in 1969 only one State, New York, paid its judges more than a Federal district judge, there are now 20 States which pay as much or more. During the same period, top executives in the private sector of the economy have received salary increases averaging 59.8 percent.

These economic factors in and of themselves make out a compelling case in favor of general salary relief for all Members of Congress, Federal executives, and judges, including bankruptcy judges, which the Congress will consider as and when it deems appropriate. But in

the case of bankruptcy judges, mere economics alone do not paint either the true or the complete picture, because bankruptcy judges have been singled out for discriminatory salary treatment by the administrative agency entrusted by Congress with the power to determine the salaries of bankruptcy judges within the limits prescribed by section 40a of the Bankruptcy Act.

Were it not for the fact that bankruptcy judges alone among all ungraded Federal personnel whose salaries are subject to the "Postal Revenue and Federal Salary Act of 1967" have been denied the salary authorized by Congress in accordance with the quadrennial salary review of 1968, we would not suppose that our circumstances warranted special legislative treatment. The fact is, however, that in each of the 6 years since the most recent Salary Commission action was implemented, bankruptcy judges have not only experienced the same substantial losses of purchasing power as the judges of other Federal courts, Members of Congress, and top level executives, but they also have been singled out by the Judicial Conference for special salary treatment, in that they have been denied receipt of from $4,350 to $6,000 of congressionally authorized salary during each of those 6 years.

It is this arbitrary and discriminatory treatment of bankruptcy judges which S. 582 would prevent in the future. We are urging congressional action after having exhausted every reasonable alternative.

The jurisdictional responsibilities of bankruptcy judges embrace a wide gamut of cases. Their cases range from exceedingly large and complicated multiplaintiff and multidefendant adversary proceedings involving vast sums of money and intricate interpretations of the appropriate interrelationship of the complex provisions of the Bankruptcy Act with those of State and Federal commercial, tax, constitutional and other laws, to the relatively simple, but no less important, consumer cases wherein the rights of ordinary citizens to be relieved from the burdens of unmanageable indebtedness are the critical issues presented.

The bankruptcy courts of this country handle more cases and directly affect more people than any other Federal court. It is extremely important that the quality of the bankruptcy bench be maintained and improved rather than jeopardized by the continued application of administrative salary actions which demoralize bankruptcy judges by depriving them of the economic incentives determined appropriate for their office by the Salary Commission, the President, and the Congress.

Mr. Chairman, that concludes the brief opening remarks I had, and I will turn the subject back to Judge Morton.

Senator BURDICK. I think you have overlooked one other difference between yourself and the regular judges. The regular judges have 100-percent retirement.

Judge CYR. Indeed.

Senator BURDICK. And what is your contribution to your own retirement?

Judge MORTON. That is a very astute observation. We have a compulsory deduction of 7 percent from our $31,750 to work toward our retirement benefits. As you know, other judges in the Federal system make no contribution whatsoever and retire on full pay.

If you recognize, as the Salary Commission did, that that is a proper point to consider in setting the salaries for the two offices, that passes us down to some $29,000, and then you apply your 42-percent inflation factor that the district judges have applied, and I think properly so, and you are talking about $17,010 in 1968 terms.

Mr. Chairman, these two judges, ex-judges who have resigned, can give you their own reasons firsthand. But let me say to you that as I talk with colleagues throughout the country, it is obvious that there is a twofold reason why this discouragement is leading people to leave the bankruptcy bench. I do not think anybody would deny that if the conference were to apply today the criteria and standards that the Congress has mandated, and still are on the statute books, everyone would receive the $36,000. But in 1969 they decided to go off on their own. They pulled in criteria not, to my mind, remotely connected with the criteria in the statute; namely, they decided on their own that there should be a parity, whatever that term may mean in this context, between the salary of magistrates and bankruptcy judges. And secondly, that the level of both should be 75 to 80 percent of the salary of district judges.

Now, there has been no indication of any intention on the part of the conference to return to the statutory criteria, and enough time has elapsed I think for them to manifest some intention to do so if they ever desire to. I cited the immediate financial problem of the bankruptcy judges as a personal and family matter; I also cite the long-range reason: if the Congress were to authorize $40,000, $42,000 or $43,000, we all realize that the Judicial Conference will second-guess it and they will decide what we get. So that is the discouraging factor that permeates and is so pervasive throughout our ranks.

Now Judge Lee, could you add some more by way of formal background, or would you rather respond to questions?

Judge Lee. I had one new fact that I wanted to call to the attention of the chairman, and that is that in January of 1975 the Bankruptcy Division of the Administrative Office of the U.S. Courts began compiling on a regular basis a statistical record of adversary of proceedings and contested matters disposed of by bankruptcy judges. Such adversary proceedings and contested matters can be appropriately described as cases within cases, and were not revealed by raw statistics on bankruptcy filing prior to this time. Adversary proceedings are in the nature of plaintiff-defendant civil actions and would be considered as separate actions if they were filed in the State courts or the district courts, and some of the contested matters are likewise in the nature of separate civil actions, but for the most part are more like motions in pending civil cases.

A collation of the information obtained by the Bankruptcy Division of the Administrative Office for the first 3 months of this calendar year indicates that bankruptcy judges are disposing of an average of 39 such matters per month. Now, if we calculate that there are 220 bankruptcy judge positions throughout the country, and find that they are disposing of 39 such matters per month, we come up with a figure of 8,580 adversary proceedings and contested matters per month which are being disposed of by bankruptcy judges nationwide. This translates into an annual figure of 102,960 such matters, and this figure is actually greater than the number of civil cases terminated by the

district courts annually. There are about 97,000 civil cases terminated annually by the district courts, and these figures indicate that the bankruptcy judges, who are only half in number, are terminating over 100,000 such matters.

There are, as a matter of fact, by way of comparison, I think about 428 district judges, when you include the senior judges.

Senator BURDICK. Could you tell me in what cases opinions are written; in what types of cases or controversies that you settle are there any written opinions?

Judge LEE. Well, on the dischargeability questions we often are required to write an opinion; on the complaint for the relief from the automatic stay which goes into effect now on the filing of a petition; on complaints to reclaim property; and on complaints to set aside the references where the person has submitted to the jurisdiction of the court. There are many types of complicated questions on which we are required to write opinions.

Judge CYR. One of the most common, Mr. Chairman, is in the area of article 9 of the Commercial Code, secured transactions, where the interplay between the powers of the trustee in bankruptcy under sections 70c and 70e has to be related to the very complicated provisions of article 9 in secured transactions. This is one in which the bankruptcy courts of this country have made more law than the Federal and State courts combined, because this issue so frequently arises in a bankruptcy context.

Judge MORTON. Mr. Chairman, I would like to ask for the assessment of a former colleague, Daniel Cowans, now that he has had a brief period off the bench. Dan, if you would proceed?

Mr. COWANS. May I stand?

Senator BURDICK. Certainly.

Mr. COWANS. Senator, I feel that there is a cold wind blowing out there, and I would like to kind of give you a picture of what is going on in the country. And to get back to the subject of what you bankruptcy judges do, let me tell you for a moment about the case I have.

These people have been talking about the big cases, and they are there and they are important. I got a call not long ago from a fellow who was distraught. I said: "All right, come on out, what is your problem." The man is a janitor in a school, and he had a lot of emotional problems. I won't go into those. They are not pertinent to the record. I found that here is a man who makes $11,500 a year, and he takes home maybe $700 or $800 a month. I found to my amazement that this man is on food stamps. And when I looked into it, he needs to be on food stamps.

We went to the first meeting and the finance company person was there. They are often there. The finance companies are not as tough as they used to be. After the meeting, we went out to the hall and they said: "Well, could you pay us something?" I said: "No, my man can't pay you anything. How much is owed to you?" "$3,500." And he said: "Well, we will have to take the furniture back." I said: "I know you will, come and get your furniture." They did. They repossessed the furniture.

If we are in a situation in this country where that kind of a salary requires somebody to be on food stamps, then I think we have some difficulties.

I visited Judge Katz the other day. I happened to have a matter down there, and I had breakfast with him. He told me that in the Chapter XIII cases they have, the wage earner plan, they are no longer getting just people who pump gas in the gas station. They are getting middle level executives and higher. They are getting doctors and lawyers filing Chapter XIII. I see all kinds of difficulties in the country.

Now, these large cases, we have a lot of them. I am involved in some in the semiconductor industry, which is a very, very sick industry in this country. You have secured creditors. You have banks. You have landlords. You have labor. You have suppliers. You have all sorts of people that are concerned.

If the true story were compiled, as to the situation of the banks in this country, there would be a lot more dismay than there is. There are a lot of bad bank loans. I am making my living to some extent as a result of some bad bank loans.

You file a Chapter XI case, sometimes as the result of the pressure of the bank. If not at that point, then when you file it you get the pressure from the bank, which under the Uniform Commercial Code has a secured claim on everything. They say: "Give me all of the money. I want everything right now, I don't care about your Chapter XI." If that happens, there is a lot of unemployment, a lot of people are thrown out of work and the unsecured creditors get nothing. The whole thing is down the drain.

A good part of what these bankruptcy judges do is in essence to hold people in place for the moment. They have to use their discretion as to whether to permit that bank or that secured creditor to take back everything, whether to let the landlord throw the debtor out, whether to let the other secured creditors take their property, whether to let the utilities chop off the utilities service as of that time. There are a lot of things that they have to do.

The bankruptcy judge, if he does his job correctly, can keep that panic button from being successfully pushed. In these chapter proceedings he can hold the thing together to do exactly what Congress intended, to see if something can be done to work these problems out. It does not just affect very large real estate developers and really large banks. There is a lot of employment entailed, and you need in that position someone with some experience, someone with some knowledge.

There is a common misunderstanding that all they do is apply some rules from the Bankruptcy Act. Far from it. They have to be involved with the Uniform Commercial Code, they have to know the law of securities. If there are public shareholders, and there are in many of these cases, the Securities and Exchange Commission will get involved. You have to know the securities law to be able to work out the rights of shareholders and what can be done. You have to know the labor law, you have to know the landlord-tenant law. Many, many of these cases involve very complicated problems.

I can tell you from my teaching that the students regard the courses that you need in order to work in the bankruptcy court as being the toughest courses at school. They are widely avoided because they are that complex. And there is a good deal of work to them. So, the notion

that the bankruptcy judge only sits on a cracker barrel signing papers is a completely erroneous notion.

I personally am dismayed at how many people who should know better not only say but sometimes write that in the bankruptcy court things are tried on affidavits. They think as if things happen without anybody being there. It is a ridiculous statement, but it is said time and time again.

I cannot overstress the need to have people with some judgment, some people with some experience, some people who will stay in place and work these things out so that you can get the rehabilitation.

Now, the story has been told, it is a true story, and I am part of it. People are leaving. I left somewhat in anger, somewhat in dismay, somewhat in disgust that nothing would ever be done. I can tell you that had the bill that you are now considering been the law at the time, there is a good chance that I would not have left. It is not merely a matter of salary. I think the justice of this bill itself is self evident, that the raising of the salary to $36,000 is long overdue. But I hope it will not be taken as any kind of an indication that if there is a general pay increase that they should not come in for further increases.

But aside from that, here I will have to restrain my statement of my true feelings—how people are treated is exceedingly important. You asked a question a couple of minutes ago about written opinions. The caseload puts an adverse effect on that. I don't know if you realize that the district judge sits there with two able law clerks. The district judge sits there with a library provided, but the bankruptcy judge has no legal assistance. There is adequate authority in the Bankruptcy Act for law libraries for bankruptcy judges, but they get virtually nothing. Almost every bankruptcy judge that I know in this country has a library that he bought out of his own pocket. You can subtract that from his salary too.

These people work long and hard, and they work on important things. My feeling is that if you take away from the present structure the right to fix a salary and return it to Congress, you will have taken important steps toward keeping those remaining people there. If you don't do that, I may pirate some of them away to work with my law firm, because we really need the assistance.

Senator Burdick. Speaking of libraries, I presume that all Federal district courts and circuit court libraries are available?

Mr. Cowans. They are said to be available. They are not always in the same building. They are not always in the same city.

Judge Morton. Mr. Chairman, as I said earlier, Judge Patchan is here with his own letter to you, and with the letter of Judge John Dilenschneider also to you, so maybe we could turn to Judge Patchan.

Judge Patchan. Mr. Chairman, I appreciate the opportunity to be heard. I probably should practice what I just observed of Mr. Cowans, learning again how to speak while standing on my feet.

Senator Burdick. You have not resigned yet, have you?

Judge Patchan. I have told my judges that I am resigning. I am awaiting their appointment of somebody fresh to take my place. Immediately upon his qualification, I will step down. I guess I am exhibit A in that regard. At least I am the freshest resignee who happens to be in Washington today.

Unfortunately, I think there may be more in various areas of the country. I come to tell you from my own experience what is going on in Ohio and throughout the country. I have had unique opportunities to attend seminars throughout the country on behalf of the Federal Judicial Center. On those occasions, I have met and spoken to bankruptcy judges throughout the land.

In regard to my own experience, I cannot add to the comments of Dan Cowans. He has expressed it very well. The underlying reason for my leaving is economic, but the trigger was the recent meeting of the Judicial Conference. Each time they met, I believe they reviewed the status of the bankruptcy court and our salary. I was advised that nothing was produced at the most recent meeting. At that point, I simply decided this must be it!

We deal in precedents. The precedent I have seen form over the past 5 or 6 years indicating lack of action or sensitivity to bankruptcy court problems by the Judicial Conference, has just left me in despair. And so I have stepped down.

Let me tell you a little bit about my background, sir. Before coming to the bench, I specialized in the practice of bankruptcy law for approximately 15 years or more. For the past 17 years, I have been a member of the faculty of one of the law schools in Cleveland, teaching debtor-creditor law and bankruptcy law. These have been my fields for a long, long time, I have practiced in those fields, and I enjoy, frankly, work on the bench within those very fields. It has been invigorating and interesting, and professionally satisfying. So it was not easy for me to reach this point, except that the dual problems of economics, of the fact that inflation was actually cutting my pay every month, and the utter despair I felt about the attitude of the Judicial Conference, has frankly done me in.

To some degree, I believe perhaps I now seek to get out of the status of a second-class judge and into, hopefully, the role of a first-class lawyer in this very field. For there is opportunity, and I must now seek to take advantage of it. My family expenses and tuitions and various obligations just do not permit me at this time to enjoy the luxury of my selfish attitude of enjoying work on the bench.

But apart from that, the same thing seems to be happening in many other areas, particularly in Ohio. Ohio is No. 2 in the country, after California, in regard to the number of bankruptcy cases filed. That is both consumer and business cases. There are 14 bankruptcy judges at work in Ohio, or at least there are that many positions, as there is quite a volume handled.

Since the first of the year, there are now four openings. One as the result of a death, three because of economic reasons. One of the three, a fine man in Cincinnati, took early retirement and advised that economic reasons had caused him to do so. John Dilenschneider of Columbus, a youthful, vigorous, and very able man, has just recently stepped down, and so have I. Now, the four openings are far and away in excess of the usual turnover in our State. Three, 20 percent, are as a result of the inequities that have developed during the time the Judicial Conference has sat on the neck of the bankruptcy judges these past years.

What this means, in addition, is a substantial burden to train new people, and a substantial cost in that regard. I am conscious of that,

particularly because of the many years I have spent in education and law. I am conscious of it even more so since I have been privileged to be on a rather select and small group of bankruptcy judges who have been members of the National Seminar Faculty. We have traveled the various parts of the country and participated in the conduct of regional seminars which bankruptcy judges attend. In addition, we also conduct the national seminar for orientation of newly appointed bankruptcy judges.

What I see forthcoming, based on the newly appointed people I have met, who seem of excellent quality, what I see, are people who I anticipate will be one-termers or less. I think Congress should be concerned about the expense that is now incurred in regard to bankruptcy judges when they are hired. It used to be after a man was appointed by his district judge, he would ge a manual perhaps from the Administrative Office in regard to certain particulars of administration, and he would get a copy of the Bankruptcy Act, or maybe go out and buy one. Then off he would go. Well, today there is a tremendous investment in every bankruptcy judge by our Government. These men are brought into Washington at the very outset of their careers. They are instructed in bankruptcy law, because it is presumed, and often it is the case, that they know nothing about bankruptcy. They are instructed in regard to judicial techniques, and they are instructed in regard to the particulars of the administration of a case, unique in bankruptcy law.

If my anticipations are correct, we have people who may be one-termers and we will have continuing instruction of recruits at the most expensive level of instruction. The cost, I think, will skyrocket in regard to instructing the men for their work. It usually take a judge anywhere from 2 to 3 years to really know what the devil he is doing when he is on the bench.

In any case, I think that Congress, in addition to what it must consider concerning the possible expense, if any pay raise of any sort is given, should consider the alternatives if it is not given.

Senator BURDICK. Would you mind suspending for about 5 minutes while I go and see what the floor situation is?

Judge PATCHAN. Not at all, sir.

[Short recess.]

Judge PATCHAN. Mr. Chairman, I would just like to conclude with a few words. I would ask your leave to introduce into the record two letters that I have brought, one from myself addressed to you, sir, and the other from Judge Dilenschneider, also addressed to you, which I think expresses extremely well precisely his feelings and mine also.

Senator BURDICK. They will be received, without objection.

[The two letters referred to follow:]

U.S. DISTRICT COURT,
SOUTHERN DISTRICT OF OHIO, EASTERN DIVISION,
Columbus, Ohio, April 29, 1975.

Hon. QUENTIN D. BURDICK,
Chairman, Subcommittee on Improvements in Judicial Machinery, Committee on the Judiciary, New Senate Office Building, Washington, D.C.

DEAR SENATOR BURDICK: I have today told Chief Judge Kinneary of the Southern District of Ohio of my intention to resign the office of Bankruptcy Judge as soon as I complete arrangements to reenter the practice of law, and that these arrangements should be final within the month. I write to you in order that the members of the Senate Judiciary Committee may know my reasons for leaving federal service.

The decision to leave the bench was not an easy one. For the past eight years I have been privileged to be part of an outstanding group of bankruptcy judges. It is with deep regret that I terminate this association. During the last several years I have been able to work upon the developing law in the dischargeability area, on new bankruptcy rules, and on considerations necessary in the complete revision of insolvency proceedings. I will miss the excitement of being on the leading edge of new law. In the past two years I have inaugurated a growing Chapter XIII program, previously unknown in Columbus, and presided over a group of trustees who have been the first in the country to use the bankruptcy court as a court of consumer regulation. I am disappointed to have to leave these projects in mid-stream.

Nevertheless, the expenses of a growing family, the problem of inflation, and the dim prospects for bankruptcy judges force me to resign. When I was first appointed in 1967 my oldest child was in the sixth grade. This fall I will have two children in college and three more in high school. Even in normal times it would cost much more to feed and clothe my family than it did eight years ago. But the times are not normal and inflation has so eroded my salary that today I actually am more poorly compensated than the day I was appointed. What is worse, there are no prospects for relief. The Judicial Conference which in 1967 allowed me maximum pay for one of the heaviest caseloads in the country, in 1969 without survey or any consideration relevant to my work illegally denied me and every other bankruptcy judge the new maximum pay set by Congress and has continued to deny it to this day. For the past few years I have lived on savings in the hope that the Judicial Conference would yield to the semi-annual requests of the National Association of Bankruptcy Judges that our pay be brought to the maximum. Twice annually these requests have been refused. I therefore see no hope for the bankruptcy judges except through your bill to amend Section 40a of the Bankruptcy Act.

Because I do not have the financial resources to continue waiting, whatever changes Congress may decide to make in the area of bankruptcy judge salaries will come too late for my personal benefit. However, I do wish to caution the committee that unless some change is made these judgeships can only be held by the independently wealthy or by those with few responsibilities, characteristics which may not be desirable in a court of this type.

I hope this explanation of one man's problem may be of some help to your committee in reviewing the legislation concerning the pay of bankruptcy judges.

Sincerely,

JOHN J. DILENSCHNEIDER.

U.S. DISTRICT COURT,
NORTHERN DISTRICT OF OHIO,
Cleveland, Ohio, April 28, 1975.

Re S. 582.

Hon. QUENTIN D. BURDICK,
Chairman, Subcommittee on Improvements in Judicial Machinery, Committee on the Judiciary, New Senate Office Building, Washington, D.C.

DEAR SENATOR: Please add my name to the tally of those who find they must leave the bench because the pay is now too low.

I had anticipated many productive years with the court. However, the static salary has become inadequate. The cost of quality education for my children is now beyond my means.

The bankruptcy bench is certainly no place for a judge who may be worried about his own bills. I leave to avoid the possibility that personal budget pressures might, even inadvertently, color a future judgment.

The more long range reason for my departure is the continuing failure of the Judicial Conference to fix salaries as Congress has directed. For six years, in disregard of the criteria provided by Congress, the Conference has substituted its own salary policy. The effect is to deny all bankruptcy judges the full $36,000 figure authorized by Congress in 1969. Thus, the only hope for many sorely pressed to remain on this bench is in Congress, via your amendment to Sec. 40 of the Bankruptcy Act. Unless Congress returns to itself the exclusive power to fix bankruptcy judges' salaries in whatever relation it deems proper to other judicial officers, I believe the already high rate of resignations from the bank-

ruptcy bench will increase substantially. This is no time to lose experience from the bankruptcy court.

Your work to update the Bankruptcy Act is sincerely appreciated by those concerned about the bankruptcy court. Please continue your efforts for the good of all judicial administration.

Yours truly,

JOSEPH PATCHAN,
Bankruptcy Judge.

Judge PATCHAN. Thank you, sir. In addition, I would also like to introduce into the record an article about myself concerning my resignation. An article which appeared in the Cleveland Plain Dealer on April 24, prophetically perhaps, on the obituary page of the paper. Although the essence of the article was accurate, the headline departs from the story, not quite unusual in the newspaper business. The headline reads "Bankruptcy Judge Calls It Quits, Can't Pay Bills." I didn't say that. They put it in the present tense, which I certainly never intended.

Senator BURDICK. You came close to it?

Judge PATCHAN. They were probably reading me between the lines. I can pay my bills, for the record, at least at present.

Senator BURDICK. It will be received, without objection.

(The Cleveland newspaper article referred to follows:)

[From the Cleveland Plain Dealer, Apr. 24, 1975]

BANKRUPTCY JUDGE CALLS IT QUITS, CAN'T PAY BILLS

(By Christine J. Jindra)

Bankruptcy Judge Joseph Patchan of U.S. District Court announced yesterday he is quitting for financial reasons.

Judge Patchan, 53, said his $31,600-a-year salary no longer could be stretched to cover his family's expenses, which include tuition for a son and a daughter in college and for a 7-year-old son in private school. He lives in Hunting Valley.

"It has reached the point where I don't want to continue to dig into my savings or become a candidate for my own services," he said.

Judge Patchan's resignation follows the April 12 announcement of Common Pleas Judge Adrian B. Fink Jr. that he is leaving the bench because he can no longer afford to live on his $34,000-a-year salary.

Judge Patchan said he might not be resigning if bankruptcy judges had been given cost-of-living raises. His last raise was 5% in 1970.

Federal judges around the country who are asking Congress for a minimum 20% pay raise have pointed out that inflation since 1970 has been more than 42%.

Judge Patchan said the federal Bankruptcy Act allows salaries of up to $36,000 for bankruptcy judges. He found it ironic that federal judges, working through their judicial conferences, have not increased salaries for bankruptcy judges to $36,000 even though they continue to lobby for increases in the $40,000 salary they get.

Judge Patchan would not speculate on how much bankruptcy judges should be paid. "What we are paid now is a good salary, but unrealistic for someone who has large family expenses and in light of what a lawyer can earn in private practice," he said.

He was appointed to office for a six-year term in 1969 by the six local federal judges. Although his term ends Dec. 31, Judge Patchan said he will serve only until a successor is appointed.

Judge Patchan said he has agreed to continue serving on the National Seminar Faculty school connected with the Federal Judicial Center in Washington and in orientation programs the center runs for new bankruptcy judges.

He said he has been asked to testify May 1 in Washington before the Senate Judiciary Committee, which is considering pay increases for judges. He has not

lobbied in the past for the raises, Judge Patchan said, but he has tried to point out the relationship between adequate salaries and good judges.

Although he plans to return to private law practice, he said he does not know if he will practice alone or join a firm. He was a bankruptcy lawyer for 15 years before his court appointment.

Judge Patchan hears cases from Cuyahoga, Lake, Lorain and Geauga counties and handles all personal reorganization bankruptcies where individuals pay off their creditors a little at a time instead of writing off all their debts.

Judge PATCHAN. Thank you, sir. It expresses, I believe, precisely what I have been trying to say.

Very briefly, there are those not only sorely pressed, but frankly in despair about the cavalier treatment that the Judicial Conference has indicated concerning the status of the bankruptcy bench. I am concerned about it because the bankruptcy court is a vital part of our judicial administration.

Thank you, sir.

Senator BURDICK. Now, in regard to these four vacancies, have any of them been filled?

Judge PATCHAN. I believe the one in Cincinnati has not been filled. On mine, it has been now 3 weeks, and they have not filled it. It may be filled within this week, I understand. The judges, I am sure, have not been waiting all of this time without seeking people, but I do not know to what extent they have interviewed or sought persons to fill this role.

Senator BURDICK. And you do not know about the other vacancies?

Judge PATCHAN. No; I do not know.

Judge MORTON. And along that same line, Mr. Chairman, we have certain charts, tables and documentary material that perhaps Judge Lee could identify and offer as exhibits.

Judge LEE. We have three exhibits that we have delivered to the reporter. One is a breakdown of bankruptcy filings for fiscal 1975 thus far as compared with fiscal 1974. We have an exhibit of some large Chapter X cases in which the bankruptcy judge is the presiding judge. and this information was furnished to us by the Securities and Exchange Commission. We also have an exhibit of the duties performed by U.S. magistrates which categorizes the types of duties they perform which would make it possible to compare their duties with our duties.

Senator BURDICK. They will be received, without objection.

[The exhibits referred to follow:]

	Fiscal year—		Numerical increase	Percent Increase
	1975 (7 mo)	1974 (7 mo)		
Voluntary straight	11, 025	85, 253	+25, 772	+30. 2
Involuntary straight	780	542	+238	+43. 9
Ch. IX	1	1		
Ch. X	123	63	+60	+95. 2
Ch. XI	1, 875	1, 162	+713	+61. 4
Ch. XII	142	74	+68	+91. 9
Ch. XIII	23, 976	16, 268	+7, 708	+47. 4
Sec. 77	0	15	−15	
Total	137, 992	103, 378	+34, 544	+33. 4

Note: Fiscal year 1975 (9 mo.), 184,655; Fiscal year 1974 (9 mos). 136,597, Total +48,058 plus +35.2 percent.

TABLE 2.—MATTERS DISPOSED OF BY U.S. MAGISTRATES DURING THE FISCAL YEARS 1972-4

Activity	Fiscal years— 1972	1973	1974	Percent change 1974 over 1972	1974 over 1973
Total, all matters	237,522	251,218	242,929	2.3	−3.3
Trial jurisdiction cases	72,082	84,580	82,705	14.7	−2.2
Petty offenses	62,915	72,746	71,463	13.6	−1.8
Minor offenses other than petty offenses	9,167	11,834	11,242	22.6	−5.0
Preliminary proceedings in criminal cases	120,723	115,121	100,152	−17.0	−13.0
Search warrants	7,338	5,961	5,649	−23.0	−5.2
Arrest warrants	36,833	33,149	27,029	−26.6	−18.5
Bail proceedings	64,518	66,095	58,034	−10.0	−12.2
Preliminary examinations	9,554	7,628	7,124	−25.4	−6.6
Removal hearings	2,480	2,288	2,316	−6.6	1.2
Additional duties	44,717	51,517	60,072	34.3	16.6
Criminal proceedings	22,336	24,337	28,028	25.5	15.2
Pretrial conferences and omnibus hearings	5,279	5,327	6,313	19.6	18.5
Motions	5,870	6,684	7,118	21.3	6.5
Postindictment arraignments	10,799	12,093	13,996	29.6	15.7
Other matters	388	233	601	54.9	157.9
Civil proceedings	22,381	27,180	32,044	43.2	17.9
Prisoner petitions	6,786	7,604	7,455	9.9	−2.0
Pretrial conferences	7,168	11,819	15,743	119.6	33.2
Motions	6,077	4,434	5,985	−1.5	35.0
Special master reports	256	306	367	43.4	19.9
Social security reviews	334	284	277	−17.1	−2.5
NARA proceedings	705	740	320	−54.6	−56.8
Other matters	1,055	1,993	1,897	79.8	−4.8

Region	Assets	Liabilities	Public investors	Presiding judge
Headquarters:				
Carolina Caribbean Corp., USDC WD, N.C., No. A-B-75-123	$31,000,000	$33,600,000	9,000	bj.
North American Acceptance Corp., USDC ND, Ga., No. B-74-290-A.	84,400,000	74,700,000	8,000	bj.
Diversified Mountaineer Corp., USDC SD, W. Va., No. 74-71-CH.	65,000,000	66,000,000	20,000	bj.
CRO:				
Woodmoor Corp., USDC D, Colo., No. 74-B-282	70,000,000	35,000,000	2,000	bj.
Omega-Alpha, Inc., USDC ND, Tex., No. Bk-3-74-454-G	45,000,000	100,000 000	25,000	bj.
Homestakc Production Co., USDC ND, Okla., No. 73-B-922	18,000,000	100,000,000	5,000	bj.
LAR:				
Equity Funding Corp. of America, USDC CD, Calif., No. 73-03467-HP.	496,700,000	379,000,000	13,000	bj.[1]
Beverly Hills Bancorp., USDC SD, Calif., No. 74-4409	182,000,000	170,000,000	2,250	bj.
NYRO: Interstate Stores, Inc., USDC SD, N.Y., No. 74-B-614	192,000,000	195,000,000	7,000	bj.

[1] The bankruptcy judge has presided over all matters prior to the commencement of plan hearings.

Source: Securities and Exchange Commission.

Judge MORTON. Mr. Chairman, that concludes our case in chief as it were. Are there any areas that you perhaps would like to touch upon that we have not mentioned?

Senator BURDICK. I have a few areas that I want to touch upon.

Could you in more detail outline the work schedule that might be considered typical for a bankruptcy judge? What do you do from the time you open the door in the morning until you quit at night?

Judge LEE. In my district, Senator, we have six places of holding bankruptcy court. We have three Federal judges, U.S. district judges, and six designated places of holding court. Those three judges divide

those places up among themselves. But there is only one bankruptcy judge to handle six designated places of holding court. Consequently, I do a good bit of travel.

The State of Kentucky is divided into two judicial district, an eastern district, which I have, and the western district. In the eastern district there are 67 counties, and I travel up to northern Kentucky, which is really the underbelly of Cincinnati, Ohio. There are lots of little river towns and a quite large population there, and I have quite a number of bankruptcy cases. And I travel to Huntington, W. Va. and the Ashland, Ky. area. Near Ashland, there are steel and chemical manufacturing plants, and I have quite a few bankruptcies there. And in the mountain area we have mining communities and some coal mine bankruptcies, and also, as a matter of fact, I have a hospital in bankruptcy up in that area.

Then we have the southeastern part of the State which is somewhat rural, and we have Lexington, where we have a lot of consumer and industrial bankruptcies, and then the capital of the State where we have quite a few, as a matter of fact, State employees in bankruptcy.

The day begins often with traveling to these places of holding court. I have to get away early, sometimes 6:30 to get there by 9 to hold court. And, of course, we typically hear 20 bankruptcy cases in a day. And when we have business bankruptcies, of course, we have to plan and allow for more docket time to hear those cases.

Senator BURDICK. You are talking about cases, you are not talking about the cases within cases?

Judge LEE. No; we are talking about first meetings. But, typically on a docket, at the same time we will set cases for trial on questions of dischargeability, or on complaints for relief from stays, or on complaints to reclaim property, and we try those things in the course of a regular day.

I would say in my situation I spend about 10 days each month holding court in places other than my home location, and 10 days, of which 6 are court days, at the home location. I would say it is not untypical to spend 4 days of the week in the courtroom and have 1 day in which you try to write opinions. The usual time to write opinions is during evenings. Since we do not have law libraries, I use the University of Kentucky law library where I do a lot of my opinion writing on my own time in the evening, simply because it is not possible to do this during the normal working day.

Senator BURDICK. For the rest of you gentlemen, is this a typical situation?

Judge MORTON. My experience, Mr. Chairman, varies to some degree. At the outset, some 12 or 13 years ago, I attempted to establish something of a circuit to hold court. Kansas' long axis is east and west, about 400 miles, and Wichita is approximately in the middle. And as the so-called money crunch of 1969 developed, and the volume of our cases correspondingly increased, I had to curtail that travel and have the lawyers bring the cases into me. So my typical day would be different than Judge Lee's in that I would ordinarily start with a conference with my chief clerk in Wichita.

Let me pause to in a sense correct that. I no longer have any clerks. I had a staff that I trained, and was very proud of. And then the Judicial Conference approved a transfer of all of those people to the clerk of the district court, and the lines of authority are quite blurred

indeed. These people really work for the clerk of the district court, and in effect, the boss, of course, is the district judge. These people are loyal enough to me that I do get the kind of help that I simply have to have. But, I simply point that out in passing.

The initial morning conference concerns new cases that have come in; there are pending requests for stays; the consumer cases are identified in which there really is no problem of any consequence to the end that the first meeting in that consumer case will not be unduly prolonged. It will just take me a minute, but let me tell you the system that we have developed to speed along these cases that really do not have any substantial controversies in them.

The difficult period is the hiatus between the time the case is first filed and the first meeting is set. That may have made some sense in 1898, but today there is need for an immediate decision on wasting assets and, indeed, of an ascertainment by a secured creditor whether there is going to be any objection to his claim of security on the non-exempt automobile. We have a trustee designate appointed the day, the moment, the case is filed, and notice to the creditors and the debtor is sent out, so that in anticipation and preparation for the first meeting, that trustee designate can go over the security documents of the bank with respect to the car, and if it is routine, as it usually is, and he can check the car value out and be prepared to make an announcement to me at the first meeting, that he abandons the property, as trustee, not casually, but after having made his investigation prior to his technical authority as trustee. The creditors no longer appoint trustees in those cases and they have not for years.

So, this sort of a make-do system has helped me handle the consumer caseload that has been as high as 160 cases a month. Back in 1970, I think, Seattle, Wash., and Wichita, Kans., were at the top of the list in just bare numbers of filings.

Now, to continue on, after I have had my initial conference, on the normal day I will go to a pretrial, a series of pretrials, or trial of a case, and in the afternoon we try to set the business cases that we have identified as including problems of more magnitude and more complexity. In the morning sessions we have been able to handle, I think without deprivation of any rights to anyone, with great expedition quite a large number of consumer cases.

I do have roughly the same experience as Judge Lee has mentioned, that if you can get 1 full day to yourself out of 5 for writing your findings of fact and your conclusions of law and your opinions in cases where the parties are entitled to a written memorandum, you are lucky. Most of us carry the cases around in our head wherever we go, and weekends, when you have the energy, are a good time to accomplish that. But, it is, without overstating the case, a full and a busy workweek.

You asked a question about how many opinions are written. It is not only the opinions, Mr. Chairman. In a number of cases we are required to write and make formal findings of fact and conclusions of law. Without a law clerk, this can be quite a tedious matter when you have a case, for example, with over 200 documentary exhibits. So I think it all adds up to a full workweek.

Senator BURDICK. What standards are prescribed in section 40 of the Bankruptcy Act to guide the Judicial Conference in fixing the salaries of the bankruptcy judges?

Judge MORTON. Let me see, it was in 1946 that Congress said, and the statute is still in effect, that these are the considerations that shall determine the setting of bankruptcy judges' salaries within the maximum set at any given time by the Congress; it is the number and the type of cases on the average, and the gross assets realized from cases, on the average, during the last preceding 10 years. Those criteria are easy to apply, and the day has long since passed when every full-time bankruptcy judge obviously is at the maximum. I do not think the Conference would disagree with that, but they still, of course, will not release the maximum salary.

There is another sort of a catchall standard in the statute, something to the effect of such other factors as may be material. Now, under that latter umbrella, perhaps the Conference has felt justified to inject wholly new criteria that I have mentioned earlier. Those are the parity with the magistrates' salaries, and to make the relationships to the district judges' salaries 75 to 80 percent. The statutory criteria mentioned specifically are easy to follow. The general suggestion that they consider material factors is obviously a wide open invitation to bring in others, but there was never any trouble until 1969. Everybody knew where they stood, or we thought we did. And then, because it has since been a whole new situation, with new criteria, our people do not know what the Conference will decide tomorrow to be more desirable as a measuring stick for our salaries.

Senator BURDICK. Have any of the bankruptcy judges presented their views before the Judicial Conference, or has any member of the Conference consulted with you?

Judge CYR. Mr. Chairman, on virtually every occasion when the Judicial Conference is about to meet we have sought such a right or such a privilege. We have never been afforded the right to be heard. We have not been accorded representation, much less membership on tiether the committee or the Conference. There is no prohibition against any one of us serving on, for instance, the Bankruptcy Committee, since it does not require a member of the Conference to serve upon it. We have no real access to the decisionmaking forum in this matter, and that is the reason that necessitates our bringing our case here.

I would like to mention in that connection, Mr. Chairman, that one of the primary functions of the Postal Revenue and Federal Salary Act of 1967, and of the creation of the Salary Commission was to eliminate this spreading like buckshot of efforts in the area of setting salaries of various Government personnel. Congress I believe at that time indicated that it was not particularly interested in continuing to hear this kind of evidence on repeated occasions. It created a Salary Commission to determine these matters and to fix the relationship between various salaries.

Our salary is one of those covered by that Salary Commission bill. The Salary Commission on two occasions has determined that the appropriate relationship between our salary and that of district judges is 90 percent, not 75 to 80 percent. They did so in 1968, they did so again in 1973 after the Judicial Conference had clearly made its view known that they thought the appropriate relationship was 75 to 80 percent.

Now, it seems to me that we have had neither the opportunity to be heard nor, indeed, has the Salary Commission action really been adhered to.

Judge MORTON. I believe that Dan Cowans has had some experience that would respond to your question.

Mr. COWANS. Never at a loss for effrontery, I visited, in the company of several of the other bankruptcy judges, two Chief Justices of the United States with this very point in mind. We went to see Chief Justice Warren; we went to see Chief Justice Burger. On both occasions we said we would like to have some opportunity of presenting our views, we would like to be heard. Always we were referred to someone else. A direct result of those conversations is that there is still no means, no vehicle whereby the bankruptcy judges can be heard by the Judicial Conference on bankruptcy matters.

Judge LEE. Could I add one word, Senator? As I read section 37 of the Bankruptcy Act, and in considering the matter of surveys provided for by section 40a in fixing salaries, you have to take into consideration the fact that there is a relationship between section 40a and section 37; section 37 requires that in the course of surveys "consideration be given to suggestions of interested parties, including district judges, referees, bar associations, trade associations and the like." And we submit that the Judicial Conference has never done that in the recent past on the salary question.

Senator BURDICK. What are you reading from?

Judge LEE. I am reading from section 37 of the Bankruptcy Act.

Senator BURDICK. The Judicial Conference has apparently imposed a requirement of parity between the salaries of magistrates and bankruptcy judges. Are the functions of the offices essentially similar? I believe that one of you this morning volunteered to make a distinction, did you not, or to present some material?

Judge MORTON. I would undertake to do that, Mr. Chairman.

Senator BURDICK. Or can you answer the question now?

Judge MORTON. I will try to answer the question. I had an opportunity to review the Supreme Court decision of *Wingo* v. *Wedding* which was handed down last summer, in July, and it lays out the distinction in the sense that it prescribes with precision the limits of the authority of the U.S. magistrates.

Now, in general, this newly created office, 1968 I believe was the date of the act, supplanted the old U.S. Commissioners and took on some of the functions that the law clerks had theretofore performed. Now, they have the authority to issue arrest warrants, to conduct preliminary examination of arrestees, to issues subpoenas, to issue warrants of removal to another district, and to release defendants on bail.

When and only when all of the parties agree, they can function in an adjudicatory fashion, and that is with respect to what are categorized and described in the statute as minor offenses. These are minor offenses carrying a penalty of 1 year and/or a fine of $1,000. In that one and only area they do have the power to make decisions if all of the parties agree.

They serve as an assistant to the judge in the conduct of pretrial and discovery matters, and then they have the catchall again of such additional duties as shall be assigned by the judge.

Now, the district court in Judge Lee's State, Kentucky, came up with this kind of an approach: they passed a local rule, and they said that the magistrate is empowered with respect to applications for habeas corpus to conduct hearings, and to make an electronic transcript of those hearings, and then to send along the transcript of the hearing with the magistrate's recommended findings of fact and conclusions to the district judge; whereupon, the local rule said, the district judge would turn on the recording, listen to it, and consider it "de novo." Well, the Supreme Court said absolutely no. The magistrate has no power to conduct an evidentiary hearing of this kind. He has only to make a preliminary report and review of the case to assist the judge at the hearing. But the case says that the person charged has the right to appear personally before the district judge, and he alone can conduct the hearing.

The case goes on to spell out some of the other duties of the magistrate that I have just enumerated, and it does drive home with unmistakable clarity the fact that there is no authority to conduct an evidentiary hearing on the part of the magistrate, let alone, as the case repeatedly points out, in no event does the magistrate have the power to make a decision. He can only recommend.

I understand there is legislation to try to turn that case around, but that is the way the law stands today.

Senator BURDICK. But in contrast, is your job almost 100 percent decisionmaking?

Judge MORTON. Yes. In bankruptcy court, that is the end of the line. We are the trial judge, and that is the final decision, and our judgments, if not appealed from, are like any other Federal court judgments. They can be executed and carried into effect.

Judge LEE. Senator, I wanted to call your attention to an interesting fact about this decision of the Judicial Conference that the salaries of magistrates and bankruptcy judges should be on a parity. That decision was made I believe initially, the first time was made at a meeting of the Judicial Conference held March 13 and 14 of 1969. On page 31 of the report of Judicial Conference proceedings on those dates it is stated "The Conference also agreed with the principle that the maximum salaries of magistrates should be on a parity with the maximum salaries paid to referees in bankruptcy." Now on the opposite page, you will note on page 30 that Judge Doyle advised the Conference that the committee, that is the Committee on Magistrates was agreed that "because of the need for experience in establishing the offices of full-time and part-time U.S. magistrates, the pilot program was desirable to assist in the transition from the commissioner system to the magistrate system."

He stated that, "The committee was of the view that such a program should be instituted at the earliest possible date, and no later than May 1, 1969."

So at the time this decision was made in March of 1969 there were, in fact, no magistrates in existence. The decision was made that these offices should be on a parity by the Judicial Conference before the magistrates program got underway.

Judge MORTON. And there is an even more compelling point, is there not, Judge Cyr?

Judge Cyr. It seems to me, Mr. Chairman, that the significance of that observation is that prior to the time the magistrate program actually got functioning, a totally different kind of jurisdiction was envisioned by some Federal judges for their magistrates, a jurisdiction which the Supreme Court and actual practice since have pared back so substantially that only the legislation which is before your committee could ever bring it back to the level that was anticipated at the time this parity relationship was struck. And we suggest not only that that is of dubious materiality in the matter, relating our salaries to theirs, but the basis upon which they did this then, from whence they have never been shaken, was totally irrelevant at that time.

Mr. Cowans. Senator, I am constrained to add one sentence. This discussion underscores the high desirability in your pending legislation on the Bankruptcy Act, for the creation of an independent bankruptcy court.

Senator Burdick. The salaries of the district court judges and bankruptcy judges have always been maintained at a comparable ratio, 3 to 4?

Judge Cyr. Mr. Chairman, the ratio of 3 to 4 was an historical accident and has occurred on only one prior occasion. Between 1946 and 1952 the ratio was 3 to 2; 1953 to 1955, it was 6 to 5; 1955–56, for a brief period it was 9 to 5; 1957–64 it was 3 to 2; in 1965 to 1969 would be the only occasion when it got to 4 to 3. And of course, it has been maintained at that rate ever since by reason of the insistence of the conference.

Senator Burdick. Gentlemen, I have a few other questions. Off the record.

[Off the record discussion.]

Mr. Burgum. There are three questions remaining. The statement was made that at the present time the agencies of the Government had authorized a relationship between the Federal judges' salaries and the bankruptcy judges' salaries of 90 percent of the Federal judges. Could someone explain in some detail precisely where that type of authorization came from?

Judge Cyr. Yes, Mr. Burgum. The Postal Revenue and Federal Salary Act of 1967 empowers the Commission on Executive, Legislative and Judicial Salaries, normally referred to as the Salary Commission, which is required to meet or was required to meet quadrennially, to review the salary rates of designated Federal judges, executive personnel and legislative personnel. District judges and bankruptcy judges are included among those designated judicial offices, and that same statute requires that the Salary Commission take into account not only what the appropriate dollar salary level for any given office is to be, but what the appropriate relationship is to be between that office and other offices also covered by the salary review.

In 1968 the Salary Commission met and it determined that the appropriate relationship between the salary of the bankruptcy judge and that of a district judge was 90 percent. Now, in the interim which ensued prior to the next deliberations of the Salary Commission, which reported eventually in 1973, the Judicial Conference caused a committee to be formed as a liaison committee for the purpose of communicating to the Salary Commission the views of the Judicial Con-

ference with respect to the appropriate salary relationships among the various Federal judicial offices covered by the salary review. And as far as I know, they did so and they communicated the 75- to 80-percent ratio which they believe, and have since enforced, as appropriate. Notwithstanding that, however, the Salary Commission came back once again in 1973 with the 90-percent ratio between the salary of bankruptcy judges and Federal district judges.

Mr. BURGUM. Now, when the Salary Commission used its criteria to establish this 90-percent ratio, am I wrong in my understanding that the criteria they used for judging the duties and responsibilities for bankruptcy judge were inaccurate? They felt that the bankruptcy judge was on a par with the hearing examiner; the Salary Commission did not accurately understand the duties on dischargeability, the limits of the hearing examiners, or that the bankruptcy judge has the power of decision which could be enforced, etc.

Judge CYR. There was obviously confusion, Mr. Burgum, between the relationship, the responsibilities and functions of commissioners of the court of claims and referees in bankruptcy. Bankruptcy judges, in fact, the trial judges of the bankruptcy courts, whereas the salary commission perceived their functions as being those of hearing, reporting, and recommending only, whereas in fact, the opposite is so. The bankruptcy judge is a trial judge, and the commissioner of the court of claims, by and large, is the one who hears and reports.

Mr. COWANS. If I may interject, I believe that the initial determination of the 90-percent ratio was made prior to the passage of the dischargeability bill, so that the judicial powers of the bankruptcy judges were considerably enhanced after the first 90-percent ratio decision.

Mr. BURGUM. That was my understanding. Yes.

Judge CYR. Not only is that so, Mr. Burgum, but in addition to that these decisions were all made prior to the adoption of the new bankruptcy rules th new Chapter XIII rules, the new Chapter XI rule, and now, as you are aware, on April 28, just this past Monday, the Chapter X and Chapter XII rules have been transmitted by the Supreme Court to your committee, and barring unfavorable action in Congress will become effective August 1 of this year, which will once again vastly broaden the jurisdictional responsibilities of bankruptcy judges.

Mr. BURGUM. Another question that we have relates to the cost of the bill, which is always a consideration for Congress to examine. The question is basically—Do you have any estimate as to what this increase in salary would cost?

Judge MORTON. Well, Mr. Burgum, as you know, we now receive a gross of $31,650. And if the balance of our authorized salary were to be released, our arithmetic indicates that the cost, overall cost would be something in excess of $700,000; $720,000 I believe.

Mr. BURGUM. Judge Patchan, earlier you had mentioned the cost of education for bankruptcy judges. Could you give us any estimate at all as to what it costs to educate a new bankruptcy judge, above and beyond the cost of the continuing education that all judges go through?

Judge PATCHAN. No, sir, I do not have the specifics in that regard. I was relating my comments to my experience as a teacher of law, and to my observations of the amount of time and effort which has

to go into the continuing education of judges at all levels of the judiciary.

Incidentally, this education has great practical effect. The result has been a substantial increase in productivity, and likely a beneficial increase in accuracy. Although again this is a guess, I think that the volume of appellate matters may be less because of the skills learned at these seminars and institutes. I would seek, if I may have leave, to submit specifics in regard to monies being spent. I will obtain them, and I would ask leave to submit them to you at a later time.

Senator BURDICK. Without objection, you may do so.

Judge PATCHAN. Thank you, sir.

Mr. BURGUM. In the figures that you later submit, would it be possible to calculate what it costs for the trip to Washington, and the period of school here? You might be able to obtain some cost-ratio breakdowns from the administrative office as to the cost of appeals to a higher court.

Judge PATCHAN. Mr. Burgum, may I also comment in this regard too. It was my experience when I was a trial lawyer making a living as a practicing lawyer, it is my observation of the bar, which is still as cantankerous as it always has been, and probably will always remain, that the newly appointed judicial officer goes through a period probably early in his career when he will have an inordinate number of appeals. Either the bar is testing his mettle, or they are unsure of his credibility. The result is that the new judge gets hit a little bit more often and gets tested. I do not know how to test this theory of mine, but it would be my belief that if such an influx as we will have in Ohio alone, of 20 percent of our numbers brand new, I suspect we are going to have a fair increase in appeals. Not only is this costly financially to the court, but certainly a burden upon the district court, and perhaps other levels at a time when they do not need extra work. I think it is part of the costs of the loss of experience that is just a companion to the problem that is now before us.

Mr. BURGUM. One final question. As you know, there is a bill now before Congress which provides for a general salary increase throughout the Federal judiciary. In the opinion of whoever wants to respond to this, would such a bill solve the problem to which you have addressed yourself today?

Judge MORTON. I believe, Mr. Burgum, that I speak fully for all of us who are so close to and involved in this problem, that that by no means would solve the problem and, indeed, it would leave it wholly unsolved. The underlying difficulty is the preemption, if that is the proper word, by the Judicial Conference of the right to impose legislative standards on our salary fixing. And as I think I said earlier in our testimony, some of our colleagues have pointed out that what is the difference if the Congress should authorize a salary of, just pick a figure, $42,000—still the last word, the last word has always been that of the Conference.

Mr. BURGUM. Then, excuse me. Go ahead, Judge.

Judge CYR. Mine was only related to that, Mr. Burgum. It was that in the matter of costs, it should be taken into account that despite the fact that the Congress has abandoned the standards for fixing salaries, such as volume of cases and the number of asset cases and the like throughout the country, the administrative office continues to conduct a survey every time even a cost-of-living increase is granted. Lord

knows how many hours of judge time and administrative time were taken up in consulting with the judicial councils of every circuit, the district judges, and all of the other people that must be consulted in the course of approving the 5.5-percent cost-of-living increase which occurred on one occasion by accident and the intervention of Congress.

Judge MORTON. Mr. Burgum, in that last connection, before we adjourn, there is a rather revealing story of how the one-time cost-of-living increase occurred, why it started at $32,000 and then ended up at $31,650. Judge Cowans, could you help us with that?

Mr. COWANS. Yes. The authorization had existed for the $36,000 and the salaries were fixed at $30,000. A certain amount of pressure led to a recommendation that evolved for an increase to $32,000. At that time it was the law, as I recall, national law to the effect that there should be no increase in salaries above 5.5 percent. The counsel for the administrative office advised that it was not required by the law, that the bankruptcy judges were not covered by this code, so that the 5.5 percent was not a requirement on the increases that could be made. Nevertheless, the standards were applied on the basis well, is it necessary, and that is all that can be obtained, so that $350 per year was chopped off that recommendation for $32,000 unnecessarily.

Judge MORTON. Could we just bother you for one more final word that I think perhaps is important; if Judge Cyr could just take a moment?

Mr. BURGUM. Yes. And I have one more question too.

Judge MORTON. Excuse me.

Mr. BURGUM. Throughout the testimony today I think the record would show that whatever has happened with the salary consideration, it has happened in the absence of any testimony, any input of any kind from the Bankruptcy Conference or the bankruptcy judges. I am speaking here of the Administrative Office. Their considerations have lacked this type of counsel. Is there any indication to any of you gentlemen, or have you heard anything that would lead you to believe that the Judicial Conference would in the future allow you to appear, or allow you to serve in any way, or to take into account your recommendations?

Judge CYR. I personally am convinced, Mr. Burgum, that before that occurs the Judicial Conference will become a different type of an agency than it is presently. It is not a democratic institution, and perhaps it was never intended to be. And of course, one of the things that rankles is when an institution is not democratically structured, it denies access on the part of those whose input might be helpful, and who have problems and grievances that they believe are entitled at least to be heard. I am satisfied on the basis of 14 years of having been concerned with this problem, which is one of the top concerns on my mind and on the minds of my colleagues, that access to us will never occur short of legislative mandate. And it is in this regard that it seems to me that in the face of the economics which exist today for the Conference not to even heed our pleas in this regard for a hearing, much less for relief, that this is evidence that it will never be any different.

Mr. BURGUM. All right. Now, before we close I would ask that anyone of the witnesses who has any further statement to make to do so at this time.

Judge CYR. There is only one thing, Mr. Burgum, that I would like very much to say.

I have had the privilege, as do most of my colleagues, of working with Federal judges, both Federal district and circuit court judges, than whom there are no finer, and whose attitudes toward the matter of the treatment of bankruptcy judges, not only in connection with salaries, but in connection with the work we perform in our courts, and the lack of access we are afforded in the forum which makes all of the decisions, the Judicial Conference, would agree with us that this is a most inappropriate manner in which to proceed. I want to distinguish between those men and the function of the Conference as I see it. I think, in fact, that there would be a very, very substantial majority of district judges in this country today who would say, of course the bankruptcy judges deserve more fair treatment in regard to their salary at this time in light of the economics. And I would simply like to make clear that I am not, and I do not think our colleagues are intending here any disparagement of those fine judges.

Mr. Cowans. I have just a brief word in addition to that. I would certainly join the implications of Judge Cyr's remarks. that a lot of these problems are not as the result of malevolence. In reading a number of the decisions of the appellate courts, I firmly believe that with amazing frequency the members of the Judicial Conference and their compatriots do not really grasp the nature of the proceedings in the bankruptcy court. It is almost a place you have to be to understand. And I think a lot of their decisions are based upon an honestly held misconception of what happens in the bankruptcy court.

Mr. Burgum. And I might add a misconception that is not dealt with adequately due to the lack of your appearance before their group.

Judge Cyr. Precisely.

Senator Burdick. If there are no other statements or questions at this time, we thank you gentlemen very much, and this will conclude our hearing.

Judge Morton. Mr. Burgum, we are all sensitive of the tremendously crowded days that you have and the burdens on your time and that of the Senator and the members of the committee, and your pressures, and we are deeply grateful for this opportunity. It is not often that people take the time to listen to us.

Senator Burdick. At this time I would like to introduce, without objection, a letter written to me by William E. Foley, who is the Deputy Director of the Administrative Office.

[The letter referred to follows:]

Communications

Administrative Office of the U.S. Courts,
Washington, D.C., April 25, 1975.

Hon. Quentin N. Burdick,
Committee on the Judiciary,
U.S. Senate,
Washington, D.C.

Dear Senator Burdick: This is in response to your letter of April 22, 1975, extending the opportunity to testify or submit a statement on behalf of the Administrative Office at the hearing to be held on May 1, 1975, on S. 582, a bill to amend Section 40 of the Bankruptcy Act.

As you know, the Judicial Conference of the United States and this office have urged the Congress to enact legislation to increase the compensation of all federal judicial officers. While we, of course, favor an increase in the salaries of referees in bankruptcy, we believe it would be unfortunate to increase the salaries of one segment of the federal judiciary without doing so for the judges of the United States Courts of Appeals, the United States District Courts, and the

United States Magistrates. Furthermore, the Judicial Conference of the United States is on record as favoring parity in the salaries of magistrates and referees in bankruptcy and the provisions of S. 582 are limited solely to referees in bankruptcy.

The foregoing represents the position both of the Judicial Conference and of the Administrative Office of the United States Courts and is submitted in response to your letter. In the circumstances I do not believe it will be necessary for any further testimony to be submitted on behalf of either the Conference or the Administrative Office.

Sincerely,

William E. Foley,
Deputy Director.

[Whereupon, at 11:55 a.m., the hearing was concluded.]

Public Law 94-217
94th Congress, H. R. 6184
February 27, 1976

An Act

To amend section 40 of the Bankruptcy Act to fix the salaries of referees in bankruptcy.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That the portion of section 40 (11 U.S.C. 68) of the Bankruptcy Act which appears before subsection (c) of such section is amended to read as follows:

Bankruptcy referees. Salary-fixing.

"a. The compensation of referees in bankruptcy shall be as follows:

"(1) Each full-time referee in bankruptcy shall receive a salary of $37,800 per annum, subject to adjustment in accordance with section 225 of the Federal Salary Act of 1967 and section 461 of title 28 of the United States Code.

2 USC 358 note.

"(2) Each part-time referee in bankruptcy shall receive a salary of not more than $18,900 per annum, subject to adjustment in accordance with section 225 of the Federal Salary Act of 1967 and section 461 of title 28 of the United States Code, and subject to further adjustment by the conference, in the light of recommendations of the councils, made after advising with the district judges of their respective circuits, and the Director. In fixing the amount of the salary to be paid to a part-time referee, consideration shall be given to the average number and types of, and the average amount of gross assets realized from, cases closed and pending in the territory which the part-time referee is to serve, during the last preceding period of ten years, and to such other factors as may be material.

"(3) Disbursement of salaries of referees shall be made monthly by or pursuant to order of the Director.

"b. The conference, in light of the recommendations of the councils, made after advising with the district judges of their respective circuits, and of the Director, may increase or decrease the salary of any part-time referee, within the limit prescribed in subdivision a(2) of this section, if there has been a material increase or decrease in the volume of business or other change in the factors which may be considered material in fixing salaries.".

SEC. 2. The next to final sentence of section 40d(2) of the Bankruptcy Act is amended by striking out "However, the rate of compensation" and all that follows down through the end of the sentence and inserting in lieu thereof the following: "However, the rate of compensation of a retired referee assigned to serve on a full-time basis in the territory of a part-time referee shall be the rate of full-time service.".

Retired referee, compensation. 11 USC 68.

Approved February 27, 1976.

LEGISLATIVE HISTORY:

HOUSE REPORT No. 94-467 (Comm. on the Judiciary).
SENATE REPORT No. 94-626 accompanying S. 582 (Comm. on the Judiciary).
CONGRESSIONAL RECORD:
Vol. 121 (1975): Oct. 23, considered and passed House.
Vol. 122 (1976): Feb. 5, considered and passed Senate, in lieu of S. 582.

ADJUSTMENT OF DEBTS OF POLITICAL SUBDIVISIONS AND PUBLIC AGENCIES AND INSTRUMENTALITIES

FRIDAY, OCTOBER 31, 1975

U.S. SENATE,
SUBCOMMITTEE ON IMPROVEMENTS IN JUDICIAL MACHINERY
OF THE COMMITTEE ON THE JUDICIARY,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10 a.m. in room 457, Russell Senate Office Building, Senator Quentin N. Burdick, presiding.

Present: Senators Burdick (presiding) and Hruska.

Also present: Tom Burgum, deputy counsel; Karen Krueger, secretary; and Harry Dixon, Senator Hruska's staff.

Senator BURDICK. This morning we are meeting to receive testimony on S. 2597, a bill to amend the Bankruptcy Act. This bill seeks to remedy the inadequacies of chapter IX of the Bankruptcy Act in its application to the problems of major municipalities by adding a new chapter XVI. This chapter would be for use by major municipalities as an alternative to chapter IX.

This bill is identical in all respects to a legislative proposal submitted to the Senate by President Ford on October 29, 1975. The proposal was submitted for our consideration because there is, in the words of the President, "the need for meaningful action to bring into balance the revenues and expenditures of a city which may need to seek relief under the Bankruptcy Act."

The use of bankruptcy reorganization proceedings to assist municipal governments in adjusting their indebtedness is not a new concept. The first effective municipal bankruptcy statute was enacted in 1936. Since that time some 350 or more cases have been filed under chapter IX of the Bankruptcy Act involving some $207 million of admitted debts.

While chapter IX has performed a valuable function during the period of its existence, in recent years it has become clear that amendment is necessary if chapter IX is to present the best vehicle necessary for reorganization of a financially troubled municipality. The report of the Commission on the Bankruptcy Laws of the United States concluded that while the concept of municipal reorganization should be retained in the bankruptcy statutes, certain amendments were needed to simplify and expedite proceedings under this chapter.

There are, of course, many specific provisions of the bill to which we must give careful consideration. Beyond the questions dealing with specific details, there are four broad areas of consideration which I think deserve our special consideration.

The first is whether it is advisable to provide for two different municipal reorganization chapters with different standards for cities of different size.

The second consideration is whether or not it is advisable to provide ready access to the courts, and if it is, do the provisions of the proposed act actually provide ready access?

Third, if a need exists for functional restructuring of a city, is there any mechanism by which this may be accomplished?

The fourth consideration is whether the proposed act has adequately provided for the maintenance of essential services during the process of reorganization.

Before calling our first witness, a copy of S. 2597 will be incorporated in the hearing record and be received without objection.

Senator HRUSKA. Mr. Chairman, may I suggest, in keeping with custom and also for the convenience of the readers of the record, that in addition to the text of the proposed bill, the record also include the President's letter of transmittal, a copy of the section by section analysis which appeared in the Congressional Record this morning, and also the text of the President's remarks on October 29.

Senator BURDICK. It will be received without objection. However, the section by section analysis will, I believe, appear as part of the prepared statement of the Department of Justice.

[The documents referred to follow:]

THE WHITE HOUSE,
Washington, D.C., October 29, 1975.

Hon. NELSON A. ROCKEFELLER,
President of the Senate, Washington, D.C.

DEAR MR. PRESIDENT: Enclosed for your consideration and appropriate reference is a legislative proposal to amend the Bankruptcy Act to add a new Chapter XVI dealing with the adjustment of debts of major municipalities.

This legislative recommendation is submitted because of the inadequacies of Chapter IX of the current Bankruptcy Act in its application to the problems of major municipalities. The attached draft legislative proposal would provide a desirable alternative to Chapter IX of the Bankruptcy Act.

A major concern of all of us is the need for meaningful action to bring into balance the revenue and expenditures of a city which may need to seek relief under the Bankruptcy Act. The attached legislative proposal will provide the incentives needed to force such a city to make the hard decisions required to achieve this important objective. The draft legislation will accomplish this without improper intrusion into the internal governmental affairs of any State.

We do not wish for any city to have to undergo bankruptcy. However, recent events remind us we cannot ignore the fact that there must be relief legislation ready and available in the event insolvency forces resort to relief under the Bankruptcy Act. I can assure you that the Executive Branch would be prepared to work with the bankruptcy court in a proceeding under the proposed Act.

Administration witnesses will be pleased to consult with and advise the Committee to which this legislation is assigned. This legislation is urgently needed. I respectfully urge its early consideration by the Congress.

Sincerely,

GERALD R. FORD.

S. 2597

A BILL To amend the Bankruptcy Act to add a new chapter thereto providing for the adjustment of the debts of major municipalities

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That the Bankruptcy Act of 1893 (30 Stat. 544), as amended, is hereby amended to add a new Chapter XVI thereto reading as follows:

Chapter XVI—Adjustment of Indebtednesses of Major Municipalities

JURISDICTION AND RESERVATION OF POWERS

Sec. 801. (a) This Act and proceedings thereunder are found and declared to be within the subject of bankruptcies and, in addition to the jurisdiction otherwise exercised, courts of bankruptcy shall exercise original jurisdiction as provided in this chapter for the composition or extension of the debts of certain public agencies or instrumentalities or political subdivisions. The court in which the petition is filed in accordance with Subsection 804(c) shall exercise exclusive jurisdiction for the adjustment of petitioner's debts and, for purposes of this chapter, shall have exclusive jurisdiction of petitioner and its property, wherever located.

(b) Nothing contained in this chapter shall be construed to limit or impair the power of any State to control by legislation or otherwise, any public agency or instrumentality or political subdivision of the State in the exercise of its political or governmental powers, including expenditure therefor: *Provided, however*, that no State law prescribing a method of composition of indebtedness of such agencies shall be binding upon any creditor who does not consent to such composition, and no judgment shall be entered under such State law which would bind a creditor to such composition without his consent.

DEFINITIONS

Sec. 802. The words and phrases used in this chapter have the following meanings unless they are inconsistent with the context.

(1) The term "attorney" means an attorney licensed to practice law by any State and includes a law partnership.

(2) The term "claim" means a demand for performance of an obligation to pay money, whether matured or unmatured.

(3) The term "composition" means a plan for payment of less than the full amount of debts provided for by the plan, with or without the extension of time for payment of such debts.

(4) The term "court" means United States District Court sitting in bankruptcy, and the terms "clerk" and "judge" shall mean the clerk and judge of such court.

(5) The term "creditor" means any person who owns a claim against the petitioner. With respect to such claims owned by a trustee under a mortgage deed of trust, or indenture, pursuant to which there are securities outstanding, other than voting trust certificates, the term "creditor" means only the trustee.

(6) The term "lien" means a security interest in property, a lien obtained on property by levy, sequestration or other legal or equitable process, a statutory or common-law lien on property, or any other variety of charge against property to secure performance of an obligation.

ELIGIBILITY FOR RELIEF

Sec. 803. (a) Any municipality with a population in excess of 1,000,000 inhabitants is eligible for relief under this chapter, if the municipality is first specifically authorized by the State to file a petition initiating a proceeding under this chapter.

(b) Any public agency or instrumentality or political subdivision subordinate to such municipality or whose responsibilities are restricted to the geographical limits thereof, including incorporated authorities, commissions and districts, for whose debts such municipality is not otherwise liable, is eligible for relief as a separate petitioner in the same proceeding in which such municipality seeks relief under this chapter if such agency, instrumentality subdivision is not prohibited from filing a petition by applicable State law.

PETITION; PROPOSED PLAN AND STATEMENT OF REVENUES AND EXPENDITURES; FILING

Sec. 804. (a) Any entity eligible for relief under Section 803 may file a voluntary petition under this chapter. The petition shall state that the petitioner is eligible to file a petition, that the petitioner is insolvent or unable to pay its debts as they mature and that it desires to effect a plan composition or extension of its debts. The petitioner shall file with its petition lists of claims outstanding

and of persons who may be adversely affected by the plan, as set forth in Section 809.

(b) A petition shall be insufficient to invoke the jurisdiction of the court unless it is accompanied by (1) a good faith plan of composition or extension of debts which petitioner certifies is in its view fair, equitable, feasible, and not unfairly discriminatory in favor of any creditor or class of creditors and (2) a statement of petitioner's current and projected revenues and expenditures adequate to establish that the budget of petitioner will be in balance within a reasonable time after adoption of the plan.

(c) The petition shall be filed with the court in whose territorial jurisdiction the municipality or the major part thereof is located, and shall be accompanied by payment to the clerk of a filing fee of $100, which shall be in lieu of the fee required to be collected by the clerk under other applicable chapters of this title, as amended.

STAY OF PROCEEDINGS

SEC. 805. (a) A petition filed under Section 804 shall operate as a stay of the commencement or the continuation of any court or other proceeding against the petitioner, its property or any officer or inhabitant of the petitioner, which seeks to enforce any claim against the petitioner; as a stay of any act or the commencement or continuation of any court proceeding to enforce any lien on taxes or assessments, or to reach any property of the petitioner; and as a stay of the application of any set-off or enforcement of any counterclaim relating to any contract, debt or obligation of the petitioner.

(b) Except as it may be terminated, annulled, modified, or conditioned by the court under Subsection (c) of this Section, the stay provided by Subsection (a) of this Section shall continue until the case is closed or dismissed or the property subject to the lien is, with the approval of the court, abandoned or transferred.

(c) On the filing of a motion seeking relief from a stay provided by Subsection (a) of this Section, the court shall set a hearing for the earliest possible date. The court may, for cause shown, terminate, annul, modify or condition such stay.

(d) The commencement or continuation of any act or proceeding other than described in Subsection (a) of this Section may be stayed, restrained, or enjoined pursuant to Rule 65 of the Federal Rules of Civil Procedure, except that a temporary restraining order or preliminary injunction may be issued without compliance with subdivision (c) of that rule.

(e) No stay, order, or decree of the court may interfere with (1) any of the political or governmental powers of the petitioners; or (2) any of the property or revenues of the petitioner necessary for essential governmental purposes; or (3) the petitioner's use or enjoyment of any income-producing property. Provided, however, that the court shall enforce the conditions attached to certificates of indebtedness issued under Subsection 811 and the provisions of the plan of compensation.

CONTEST AND DISMISSAL OF PETITION

SEC. 806. (a) Any creditor may file a complaint in the bankruptcy court contesting the petition for relief under this chapter or stating any objection he has to the plan. The complaint may be filed at any time up to ten days before the hearing on the confirmation of the plan or within such other times as may be directed by the court.

(b) The court may, upon notice to the creditors and a hearing following the filing of such a complaint, dismiss the proceeding if it finds that the petition was not filed in good faith, that it does not meet the provisions of this chapter, that it has not been prosecuted with reasonable diligence, or that there is no substantial likelihood that a plan of composition will be approved by the court.

NOTICES

SEC. 807. (a) The clerk shall give prompt notice of the commencement of a proceeding under this chapter to the State and to the Securities and Exchange Commission. As creditors and other persons who may be materially and adversely affected by the plan are identified, the clerk shall give such persons notice of the commencement of the proceeding, a summary of the provisions of the plan and any proposed modification of the plan, and of their right to request a copy of the plan, or modification.

(b) The clerk shall also give notice to all creditors of the time permitted for accepting or rejecting a plan or any modification thereof. Such time shall be 90 days from the filing of the plan or modification unless the court for good cause shall set some other time.

(c) The clerk shall also give notice to all creditors (1) of the time permitted for filing a complaint objecting to confirmation of a plan, (2) of the date set for hearing objections to such complaint, (3) of the date of hearing of a complaint seeking dismissal of the petition, and (4) of the date of the hearing on confirmation of the plan.

(d) All notices given by the clerk shall be given in the manner directed by the court; however, the court may issue an order at any time subsequent to the first notice to creditors directing that those persons desiring written notice file a request with the court. If the court enters such an order persons not so requesting will receive no further written notice of proceedings under the chapter.

(e) Cost of notice shall be borne by the petitioner, unless the court for good cause determines that the cost of notice in a particular instance should be borne by another party.

REPRESENTATION OF CREDITORS

SEC. 808. For all purposes of this chapter any creditor may act in person or by an attorney or a duly authorized agent or committee. Where any committee, organization, group, or individual shall assume to act for or on behalf of creditors, such committee, organization, group, or individual shall first file with the court in which the proceeding is pending a list of the creditors represented, giving the name and address of each and describing the amount and character of the claim of each; copies of the instrument or instruments in writing signed by such creditors conferring the authority for representation; and a copy of the contract or contracts of agreement entered into between such committee, organization, group, or individual and the represented creditors, which contract or contracts shall disclose all compensation to be received, directly or indirectly for such representation, which agreed compensation shall be subject to modification and approval by the court.

LIST OF CLAIMS AND PERSONS ADVERSELY AFFECTED

SEC. 809. (a) The list of claims filed with the petition shall include, to the extent practicable, the name of each known creditor to be affected by the plan, his adress so far as known to the petitioner, and a description of each claim showing its amount and character, the nature of any security therefor and whether the claim is disputed, contingent or unliquidated as to amount. With respect to creditors not identified, the petition shall set forth the reasons identification is not practicable, and shall specify the character of claim involved. The list shall be supplemented as petitioner becomes able to identify additional creditors.

(b) If the proposed plan requires revision of assessments so that the proportion of special assessments or special taxes to be assessed against some real property will be different from the proportion in effect at the date the petition is filed, the holders of record of title, legal or equitable, to such real property shall be deemed persons adversely affected and shall be similarly listed.

(c) The court may for cause modify the requirements of Subsections (b) and (c) of this Section.

PROOFS OF CLAIM

SEC. 810. Unless an objection is made by any party in interest, the claim of a creditor that is not disputed, is established by the list of claims filed pursuant to Section 809. The court may set a date by which proofs of claim of unlisted creditors and of creditors whose listed claims are disputed must be filed. If the court does not set such a date, the proofs must be filed before the entry of the order of confirmation. The clerk shall give notice to each person whose claim is listed as disputed in the manner directed by the court.

DEBT CERTIFICATES

SEC. 811. During the pendency of a proceeding for a plan of composition or extension under this chapter, or after the confirmation of the plan if the court has retained jurisdiction, the court may, upon good cause shown, authorize the petitioner to issue certificates of indebtedness for cash, property or other consideration, under such terms and conditions and with such security and priority

in payment over existing obligations as the court may approve. Notwithstanding any other provision of law including Section 819 of this chapter, the court shall have plenary jurisdiction of any action which may be brought against petitioner to enforce compliance with the terms of any such certificates of indebtedness.

PRIORITIES

SEC. 812. The following shall be paid in full in advance of the payment of any distribution to creditors under a plan, in the following order:

(1) The cost and expenses of administration which are incurred by the petitioner subsequent to the filing of a petition under this chapter.

(2) Debts owed for services and materials actually provided within four months before the date of the filing of the petition under this chapter.

(3) Debts owing to any person or entity, which by the laws of the United States (other than this Act) are entitled to priority.

PLAN OF ADJUSTMENT

SEC. 813. The plan of composition or extension sought under this chapter may include provisions modifying or altering the right of creditors generally, or of any class of them, secured or unsecured, either through issuance of new securities of any character, or otherwise, and may contain such other provisions and agreements not inconsistent with this chapter as the parties may desire, including provisions for the rejection of executory contracts and unexpired leases.

VOTING ON ACCEPTANCE OF PLAN

SEC. 814. (a) A plan of composition or extension may be confirmed only if, of the creditors voting in writing to accept or reject the plan, those holding two-thirds in amount of each class materially and adversely affected have voted to accept: *Provided, however*, that no such acceptance shall be required from any class which, under the plan, is to be paid in cash the value of its claims or is to be afforded such method of protection as will, consistent with the circumstances of the particular case, equitably and fairly provide for the realization of the value of its claims.

(b) Unless his claim has been disallowed, any creditor who is included on the list filed pursuant to Section 809 or who files a proof of claim pursuant to Section 810 is entitled to vote to accept or reject a plan or modification thereof within the time set pursuant to Subsection 807(b). Claims owned, held or controlled by the petitioner are not eligible to vote.

(c) The holders of all claims regardless of the manner in which they are evidenced, which are payable without preference out of funds derived from the same source or sources shall be of one class. The holders of claims for the payment of which specific property or revenues are pledged, or which are otherwise given preference as provided by law, shall constitute a separate class or classes of creditors.

(d) If any controversy shall arise as to whether any creditor or class of creditors shall or shall not be materially and adversely affected, the issue shall be determined by the judge, after hearing, upon notice to the parties interested.

MODIFICATION OF PLAN

SEC. 815. Before a plan is confirmed, changes and modifications may be made therein with the approval of the judge after hearing and upon such notice to creditors as the judge may direct, subject to the right of any creditor who has previously accepted the plan to withdraw his acceptance in writing, within a period to be fixed by the judge, if, in the opinion of the judge, the change or modification will materially and adversely affect such creditor; and if any creditor having such right of withdrawal shall not withdraw within such period, he shall be deemed to have accepted the plan as changed or modified: *Provided, however*, That the plan as changed or modified shall comply with all the provisions of this chapter and shall have been accepted in writing by the petitioner.

HEARING ON CONFIRMATION OF PLAN

SEC. 816. (a) Within a reasonable time after the expiration of the time within which a plan and any modifications thereof may be accepted or rejected, the court shall set a hearing on the confirmation of the plan and modifications, and

the clerk shall give notice of the hearing and time allowed for filing objections as provided in Subsection 807(c).

(b) Any creditor, or any other party in interest may file a complaint objecting to the confirmation of the plan. The complaint shall be served on the petitioner, and such other persons as may be designated by the court, at any time prior to the date of the hearing on confirmation or such earlier date as the court may set.

(c) Before concluding the hearing on confirmation of the plan the judge shall inquire whether any person promoting the plan or doing anything of such a nature, has been or is to be compensated, directly or indirectly, by both the petitioner and any creditor, and shall take evidence under oath to ascertain whether any such practice obtains. After such examination the judge shall make an adjudication of this issue, and if he finds that any such practice obtains, he shall forthwith dismiss the proceeding and tax all of the costs against such person, or against the petitioner, unless such plan be modified within the time to be allowed by the judge so as to eliminate the possibility of any such practice.

(d) At the conclusion of the hearing, the judge shall make written findings of fact and his conclusions of law thereon, and shall enter a decree confirming the plan if he finds and is satisfied that (1) it is fair, equitable, feasible and not unfairly discriminatory in favor of any creditor or class of creditors; (2) it complies with the provisions of this chapter; (3) it has been accepted by creditors as required in Section 814; (4) all amounts to be paid by the petitioner for services or expenses incident to the composition have been fully disclosed and are reasonable; (5) the offer of the plan and its acceptance are in good faith; (6) the petitioner is authorized by law to take all action necessary to be taken by it to carry out the plan; and (7) it appears from petitioner's current and projected revenues and expenditures that the budget of the petitioner will be in balance within a reasonable time after adoption of the plan. If not so satisfied, the judge shall enter an order dismissing the proceeding. No case shall be reversed or remanded for want of specific or detailed findings unless it is found that the evidence is insufficient to support one or more of the general findings required in this section.

EFFECT OF CONFIRMATION

Sec. 817. (a) The provision of a confirmed plan shall be binding on the petitioner and on all creditors, whether or not they are affected by it, whether or not their claims have been listed, filed, or allowed, and whether or not they have accepted the plan.

(b) The confirmation of a plan shall extinguish all claims against the petitioner provided for by the plan other than those excepted from discharge by the plan or order confirming the plan.

DUTY OF PETITIONER AND DISTRIBUTION UNDER PLAN

Sec. 818. (a) The petitioner shall comply with the provisions of the plan and the orders of the court relative thereto and shall take all actions necessary to carry out the plan.

(b) Subject to the provisions of Subsection (c), distribution shall be made in accordance with the provisions of the plan to creditors (1) whose proofs of claim have been filed and allowed or (2) whose claims have been listed and are not disputed. Distribution to creditors holding securities of record shall be made to the record holders as of the date the order confirming the plan becomes final.

(c) When a plan requires presentment or surrender of securities or the performance of any other act as a condition to participation under the plan, such action must be taken not later than five years after the entry of the order of confirmation. Persons who have not within such time presented or surrendered their securities or taken such other action shall not participate in the distribution under the plan. Any securities, monies, or other property remaining unclaimed at the expiration of the time allowed for presentment or surrender of securities or the performance of any other act as a condition to participation in the distribution under a confirmed plan shall become the property of the petitioner.

(d) The court may direct the petitioner and other necessary parties to execute and deliver or to join in the execution and delivery of any instruments required to effect a transfer of property pursuant to the confirmed plan and to perform such other acts, including the satisfaction of liens, as the court may determine to be necessary for the consummation of the plan.

RETENTION OF JURISDICTION

SEC. 819. The court may retain jurisdiction of a proceeding under this chapter for such period as it determines is necessary to assure execution of the plan.

REFERENCE OF ISSUES AND COMPENSATION

SEC. 820. (a) The judge may refer any special issues of fact to a referee in bankruptcy, magistrate or another special master for consideration, the taking of testimony, and a report upon such special issues of fact, if the judge finds that the condition of his docket is such that he cannot take such testimony without unduly delaying the dispatch of other business pending in his court, and if it appears that such special issues are necessary to the determination of the case. Only under special circumstances shall reference be made to a special master who is not a referee in bankruptcy or a magistrate. A general reference of the case to a master shall not be made, but the reference, if any, shall be only in the form of requests for findings of specific facts.

(b) The court may allow reasonable compensation for the services performed by any such special master who is not a salaried Federal employee, and the actual and necessary expenses incurred in connection with the proceeding, including compensation for services rendered and expenses incurred in obtaining the deposit of securities and the preparation of the plan, whether such work may have been done by the petitioner or by committees or other representatives of creditors, and may allow reasonable compensation for the attorneys or agents of any of the foregoing: *Provided, however*, That no fees, compensation, reimbursement, or other allowances for attorneys, agents, committees, or other representatives of creditors shall be assessed against the petitioner or paid from any revenues, property, or funds of the petitioner except in the manner and in such sums, if any, as may be provided for in the plan of adjustment. An appeal may be taken from any order making such determination or award to the United States Court of Appeals for the circuit in which the proceeding under this chapter is pending, independently of other appeals which may be taken in the proceeding, and such appeal shall be heard summarily.

SEPARABILITY

SEC. 821. If any provision of this chapter, or the application thereof to any agency, instrumentality, or subdivision is held invalid, the remainder of the chapter, or the application of such provision to any other agency or instrumentality or political subdivision shall not be affected by such holding.

[From the Congressional Record, Oct. 29, 1975]

TEXT OF REMARKS BY THE PRESIDENT, DELIVERED AT THE NATIONAL PRESS CLUB, WASHINGTON, D.C., OCTOBER 29, 1975 AS REPRINTED IN THE CONGRESSIONAL RECORD, OCTOBER 29, 1975, pp. S18836–S18837

Today I want to talk to you about a matter of concern to all Americans.

New York City, where one out of every 25 Americans lives, through whose "Golden Door" untold millions have entered this land of liberty, faces a financial showdown.

The time has come for straight talk—to these eight million Americans and to the other 206 million Americans to whom I owe the duty of stating my convictions and conclusions, and to you, whose job it is to carry them throughout the Nation and around the world.

The time has come to sort facts and figures from fiction and fear-mongering in this terribly complex situation. The time has come to say what solutions will work and which should be cast aside.

And the time has come for all Americans to consider how the problems of New York and the hard decisions they demand, foreshadow and focus upon potential problems for all Federal, State and local governments—problems which demand equally hard decisions from them.

One week ago New York City tottered upon the brink of financial default which was deferred only at the eleventh hour.

The next day Mayor Beame testified here in Washington that the financial resources of the city and state of New York were exhausted. Governor Carey agreed.

It's now up to Washington, they said, and unless the Federal Government intervenes, New York City within a short time will no longer be able to pay its bills.

The message was clear: Responsibility for New York City's financial problems is being left on the front doorstep of the Federal Government—unwanted and abandoned by its real parents.

Many explanations have been offered about what led New York City deeper and deeper into this quagmire.

Some contend it was long-range economic factors such as the flight to the suburbs of the city's more affluent citizens, the migration to the city of poorer people, and the departure of industry.

Others argue that the big metropolitan city has become obsolescent, that decay and pollution have brought a deterioration in the quality of urban life, and that New York's downfall could not be prevented.

Let's face one simple fact: most other cities in America have faced these same challenges, and they are still financially healthy today. They have not been luckier than New York; they simply have been better managed.

There is an old saying: "The harder you try, the luckier you get." I like that definition of "luck".

During the last decade, the officials of New York City have allowed its budget to triple. No city can expect to remain solvent if it allows its expenses to increase by an average of 12 percent every year, while its tax revenues are increasing by only 4 to 5 percent a year.

As Al Smith, a great Governor who came from the sidewalks of New York, used to say: "Let's look at the record."

The record shows that New York City's wages and salaries are the highest in the United States. A sanitation worker with three years experience now receives a base salary of nearly $15,000 a year. Fringe benefits and retirement costs average more than 50 percent of base pay. Four-week paid vacations and unlimited sick leave after only one year on the job.

The record shows that in most cities, municipal employees have to pay 50 percent or more of the cost of their pensions. New York City is the only major city in the country that picks up the entire burden.

The record shows that when New York's municipal employees retire they often retire much earlier than in most cities and at pensions considerably higher than sound retirement plans permit.

The record shows New York City has 18 municipal hospitals; yet, on an average day, 25 percent of the hospital beds are empty. Meanwhile, the city spends millions more to pay the hospital expenses of those who use private hospitals.

The record shows New York City operates one of the largest universities in the world, free of tuition for any high school graduate, rich or poor, who wants to attend.

As for New York's much-discussed welfare burden, the record shows more than one current welfare recipient in ten may be legally ineligible for welfare assistance.

Certainly I do not blame all the good people of New York City for their generous instincts or for their present plight. I do blame those who have misled the people of New York City about the inevitable consequences of what they were doing over the last 10 years.

The consequences have been:

A steady stream of unbalanced budgets;

Massive growth in the city's debt;

Extraordinary increases in public employee contracts.

And total disregard of independent experts who warned again and again that the city was courting disaster.

There can be no doubt where the real responsibility lies. And when New York City now asks of the country to guarantee its bills, it can be no surprise that many other Americans ask why.

Why, they ask, should they support advantages in New York that they have not been able to afford for their own communities?

Why, they ask, should all the working people of this country be forced to rescue those who bankrolled New York City's policies for so long—the large investors and big banks?

In my judgment, no one has yet given these questions a satisfactory answer.

Instead, Americans are being told that unless the rest of the country bails out New York, there will be catastrophe for the United States and perhaps for the world.

Is this scare story true?

Of course there are risks that default could cause temporary fluctuations in the financial markets. But these markets have already made a substantial adjustment in anticipation of a possible default by New York City.

Claims also are made that because of New York City's troubles, other municipalities will have grave difficulty selling their bonds. I know this troubles many thoughtful citizens.

But, the New York City record of bad financial management is unique among municipalities. Other communities have a solid reputation for living within their means. In recent days and weeks, other local governments have gone to investors with clean records of fiscal responsibility and have had no difficulty raising funds.

The greater risk is that any attempt to provide a Federal blank check for the leaders of New York City would ensure that no long-run solution to the city's problems will ever occur.

I can understand the concern of many citizens in New York and elsewhere. I understand because I am also concerned.

What I cannot understand—and what nobody should condone—is the blatant attempt in some quarters to frighten the American people and their representatives in Congress into panicky support of patently bad policy. The people of this country will not be stampeded; they will not panic when a few desperate New York officials and bankers try to scare New York's mortgage payments out of them.

We have heard enough scare talk.

What we need now is a calm, rational decision as to what the right solution is—the solution that is best for the people of New York and best for all Americans.

To be effective, the right solution must meet three basic tests:

It must maintain essential public services for the people of New York City. It must protect the innocent victims of this tragedy. There must be policemen on the beat, firemen in the station, nurses in the emergency wards.

Second, the solution must assure that New York City can and will achieve and maintain a balanced budget in the years ahead.

And third, the right solution must guarantee that neither New York City nor any other American city ever becomes a ward of the Federal Government.

Let me digress a minute to remind you that under our constitutional system, both the cities and the Federal Government were the creatures of the States. The States delegated certain of their sovereign powers—the power to tax, police powers and the like—to local units of self-government. And they can take these powers back if they are abused.

The States also relinquished certain sovereign powers to the Federal Government—some altogether and some to be shared. In return the Federal Government has certain obligations to the States.

I see a serious threat to the legal relationships among our Federal, State and local governments in any congressional action which could lead to disruption of this traditional balance. Our largest city is no different in this respect than our smallest town. If Mayor Beame doesn't want Governor Carey to run his city, does he want the President of the United States to be acting Mayor of New York?

Now, what is the solution to New York's dilemma?

There are at least eight different proposals under consideration by the Congress intended to prevent default. They are all variations of one basic theme: that the Federal Government would guarantee the availability of funds to New York City.

I can tell you now that I am prepared to veto any bill that has its purpose a Federal bail-out of New York City to prevent a default.

I am fundamentally opposed to this so-called solution, and I will tell you why.

Basically, it is a mirage. By giving a Federal guarantee we would be reducing rather than increasing the prospect that the city's budget will ever be balanced. New York City's officials have proved in the past that they will not face up to the city's massive network of pressure groups as long as any alternative is available. If they can scare the whole country into providing that alternative now, why shouldn't they be confident they can scare us again into providing it three years from now? In short, it encourages the continuation of "politics as usual" in New York—which is precisely not the way to solve the problem.

Such a step would set a terrible precedent for the rest of the Nation. It would promise immediate rewards and eventual rescue to every other city that follows

the tragic example of our largest city. What restraint would be left on the spending of other local and state governments once it becomes clear that there is a Federal rescue squad that will always arrive in the nick of time?

Finally, we must all recognize who the primary beneficiaries of a Federal guarantee program would be. The beneficiaries would not be those who live and in New York City because the really essential public services must and will continue.

The primary beneficiaries would be the New York officials who would thus escape responsibility for their past follies and be further excused from making the hard decisions required now to restore the city's fiscal integrity.

The secondary beneficiaries would be the large investors and financial institutions who purchased these securities anticipating a high rate of tax-free return.

Does this mean there is no solution? Not at all. There is a fair and sensible way to resolve this issue, and this is the way to do it.

If the city is unable to act to provide a means of meeting its obligations, a new law is required to assure an orderly and fair means of handling the situation.

As you know, the Constitution empowers the Congress to enact uniform bankruptcy laws. Therefore, I will submit to the Congress special legislation providing the Federal courts with sufficient authority to preside over an orderly reorganization of New York City's financial affairs—should that become necessary.

How would this work? The city, with State approval, would file a petition with the Federal District Court in New York under a proposed new chapter XVI of the Bankruptcy Act. The petition would state that New York City is unable to pay its debts as they mature and would be accompanied by a proposed way to work out an adjustment of its debts with its creditors.

The Federal Court would then be authorized to accept jurisdiction of the case. Then there would be an automatic stay of suits by creditors so that the essential functions of New York City would not be disrupted.

It would provide a breathing space for an orderly plan to be developed so that the city could work out arrangements with the creditors.

While New York City works out a compromise with its creditors the essential governmental functions of the city would continue.

In the event of default, the Federal Government will work with the court to assure that police, fire and others essential services for the protection of life and property in New York are maintained.

The proposed legislation will include provision that as a condition of New York City petitioning the court, the city must not only file a good faith plan for payments to its creditors but must also present a program for placing the fiscal affairs of the city on a sound basis.

In order to meet the short term needs of New York City the court would be empowered to authorize debt certificates covering new loans to the city which would be paid out of future revenues ahead of other creditors.

Thus, the legislation I am proposing will do three essential things.

First, it will prevent, in the event of a default, all New York City funds from being tied up by lawsuits.

Second, it will provide the conditions for an orderly plan to be developed for payments to New York's creditors over the long term.

Third, it will provide a way for new borrowing to be secured by pledging future revenues.

I don't want anybody misled. This proposed legislation will not, by itself, put the affairs of New York City in order. Some hard measures must be taken by the officials of New York City and New York State. They must either increase revenues or cut expenditures or devise some combination that will bring them to a sound financial position. Careful examination has convinced me that those measures are neither beyond the realm of possibility nor beyond the demands of reason. If they are taken, New York City will, with the assistance of the legislation I am proposing, be able to restore itself as a fully solvent operation.

To summarize, the approach I am recommending is this: If New York fails to act in its own behalf, orderly proceedings would then be supervised by a Federal Court.

The ones who would be most affected by this course would be those who are now fighting tooth and nail to protect their authority and their investments: New York officials and the city's creditors. The creditors will not be wiped out; how much they will be hurt will depend upon the future conduct of the city's leaders.

For the people of New York, this plan will mean that essential services will continue. There may be some temporary inconveniences, but that will be true of any solution that is adopted.

For the financial community, the default may bring some temporary difficulties but the repercussions should not be large or long-lasting.

Finally, for the people of the United States, this means that they will not be asked to assume a burden that is not of their own making and should not become their responsibility. This is a fair and sensible way to proceed.

There is a profound lesson for all Americans in the financial experience of our biggest and richest city.

Though we are the richest Nation in the world, there is a practical limit to our public bounty, just as there is to New York's.

Other cities, other States as well as the Federal Government are not immune to the insidious disease from which New York is suffering. This sickness is brought on by years and years of higher spending, higher deficits, more inflation and more borrowing to pay for higher deficits, more deficits and on and on.

Those who have been treating New York's financial sickness have been prescribing larger and larger doses of the same political stimulants that has proved so popular and successful in Washington for so many years.

None of us can point a completely guiltless finger at New York. None of us should now derive comfort or pleasure from New York's anguish.

But neither can we let the contagion spread.

As we work with the people of New York to overcome their difficulties—and they will—we must never forget what brought this great center of human civilization to the brink.

If we go on spending more than we have, providing more benefits and services than we can pay for, then a day of reckoning will come to Washington and the whole country just as it has to New York.

Let me conclude with one question of my own:

When that day of reckoning comes, who will bail out the United States of America?

Thank you.

Senator BURDICK. Our first witness is Antonin Scalia, Assistant Attorney General, Office of Legal Counsel, Department of Justice. He is accompanied by Robert Gerard, Deputy Assistant Secretary, Department of the Treasury, and Russell Chapin, Chief, General Claims Section, Civil Division, Department of Justice.

Following these witnesses will be Joseph Patchan, a former bankruptcy judge and now a practicing bankruptcy attorney in Cleveland, Ohio.

Our final witness will be Vern Countryman, professor of law at Harvard University Law School. Mr. Countryman is a noted scholar in this field.

Before we proceed with the witnesses, however, I yield to my colleague from Nebraska.

Senator HRUSKA. Thank you, Mr. Chairman.

I shall insert the bulk of my statement. I shall just engage in a few brief remarks as to the nature and the character of our mission here today.

Our task is relatively simple. It is an exercise of creating a method or procedure which will be available to cities and states who find themselves in a situation similar to that which exists in New York City.

Now, it does not, in and of itself, seek to impose any course of conduct or any option upon New York State or New York City. It simply makes something available to them should they want to turn to this method to try to extricate themselves from a very distressing and troublesome situation. The idea of affording other types of relief is to be considered in other bills before the Congress, and the decision on any other fashion of dealing with this situation will be for the Congress and for the President or some combination of the decisions of each of them.

Mr. Chairman, I want to commend you for expediting hearing on this bill, because, should it become necessary to resort to this particular procedure, time is of the essence. And it will be very, very fine indeed if we can come up with something at an early date and refer it to the Congress, to the Senate for its attention. I understand that the other body has a proposed measure that they are studying. By diligent application of of the time and resources of our staff and ourselves, it is hoped that we can make timely progress with the disposition of this bill.

[The prepared statement of Senator Hruska follows:]

Statement of Senator Roman L. Hruska

Mr. Chairman, I want to take this opportunity to commend you for the timeliness with which these hearings are being held. Wednesday, President Ford proposed the addition of a new Chapter XVI to the bankruptcy laws to provide a remedy for New York City's fiscal problems. That proposal was introduced by you yesterday, Mr. Chairman, as a bill which I have co-sponsored.

I am opposed to a federal bail-out of New York City. I think the majority of the American people feel the same way. The bill we consider today will not provide for any federal guarantee but would instead allow New York City to formulate and execute in an orderly manner a plan to solve its fiscal problems. It would provide protection for creditors, yet allow the city to maintain essential services, raise new funds and rehabilitate itself financially.

Mr. Chairman, this is a reasonable approach to the New York City problem. The taxpayers of this country will not tolerate the use of their tax dollars to pay New York City's debts. The bankruptcy plan under the new chapter created by the bill *would not* use tax dollars from non-New Yorkers.

The President's plan gives New York City the choice of increasing revenues or cutting expenditures or coming up with another proposal to bring financial solvency. Under the proposed legislation, New York City can get back on the right financial track.

Mr. Chairman, while I am not prepared to endorse at this time each and every provision of this bill, I believe the bill will serve as a useful starting point for the subcommittee and the Senate to provide legislation tailored to the needs of a major municipality in need of adjusting its debts. I am certain that the testimony that we are about to receive will be very helpful in that regard.

We will hear testimony from several distinguished experts in the field of bankruptcy law. Let us hope they can point out the strengths and weaknesses of this bill and help us reach an agreement with those who have been critical of its approach.

This is a particularly appropriate solution. It will enable New Yorkers to solve their own problem, retain their dignity as citizens and prove they can manage their own affairs. They will not be forced to face the degradation of another handout from Uncle Sam.

President Ford made some comments Wednesday on proposing the legislation which I believe bears repeating. He said:

"By giving a Federal guarantee we would be reducing rather than increasing the prospect that the city's budget will ever be balanced . . If the city is unable to act to provide a means of meeting its obligations, a *new law* is required to assure an orderly and fair means of handling the situation. I don't want anybody misled. This proposed legislation will not, by itself, put the affairs of New York City in order. Some hard measures must be taken by the officials of New York City and New York State."

Senator Burdick. Mr. Scalia, your full statement will be part of the record. You may proceed in any manner you wish.

[The prepared statement of Antonin Scalia, Assistant Attorney General, Office of Legal Counsel follows:]

Prepared Statement of Antonin Scalia, Assistant Attorney General, Office of Legal Counsel

Mr. Chairman and Members of the Subcommittee: I am pleased to appear, at the request of the Subcommittee, to discuss the Administration's bill to add

a new chapter to the Bankruptcy Act dealing with the adjustment of debts of major municipalities. None of us happily considers the prospect of any large city's being unable to meet its financial obligations. Recent events with respect to the City of New York strongly suggest, however, that it is essential to have laws in place which can handle such an occurrence. Chapter IX of the Bankruptcy Act, now available to all municipalities, is in a number of respects inadequate for very large cities.

A feasible bankruptcy proceeding is vital, since it is the one means of enabling the functioning of a city to continue in an orderly fashion while an adjustment of its debts is negotiated with its creditors. The indispensable effect of a proceeding is to permit a stay of all legal actions, in both State and Federal courts, and a stay of private self-help remedies, such as the set-off by banks of the value of their claims against city payroll funds on deposit, which could have the effect of throwing the city into disorder.

The provisions of Chapter IX of the Bankruptcy Act prevent a municipal bankruptcy proceeding from being commenced, and a stay from being entered, until the city has submitted to the court a plan of adjustment which already has the approval of 51 percent of its creditors. (A preliminary stay may be obtained if the city can certify that it is seeking such 51 percent approval and has "a reasonable prospect of . . . acceptance within a reasonable time.") In the case, for example, of a city of one million or more in population, with the volume and dispersal of debt obligations which such size would normally entail, merely locating a majority of creditors within a short period of time—much less obtaining the requisite approval or "reasonable prospect" of such approval—would be a formidable, and probably impossible, task. For this reason alone, some alteration of the present provisions for large cities is essential.

There are, moreover, other respects, less crucial but nonetheless important, in which the existing law is inappropriate for major municipal bankruptcy.

The notice provisions of Chapter IX are extraordinarily cumbersome when large numbers of creditors, many of whom may have relatively insubstantial interests in the proceedings, are involved. The mere expense of providing written notice in all cases would be enormously wasteful.

Any city of major size may have a number of incorporated authorities, commissions and districts which, though subordinate to it, are financially independent in the sense that the city is not liable for their debts Likewise, some State-created governmental entities may operate within the city's limits. Some of these units, either because they receive financial income from the city, or because they are affected by the general disruption which the city's insolvency causes, may be rendered insolvent at the same time. The present law contains no explicit provision which would enable the bankruptcy of all of these entities to be handled concurrently in a single proceeding, rather than individually by separate judges.

Chapter IX requires the plan of adjustment, before it can be accepted by the court, to be approved by two-thirds in amount of each class of creditors. Since, as noted above, in the case of a very large city many of these creditors may be either unreachable or uninterested in voting, the two-thirds requirement may realistically amount to 80 percent of those voting.

Chapter IX requires written proof of each claim by each creditor. The paper burden, in the case of a major city, would be enormous.

The same is true of Chapter IX's requirement that the terms of the plan itself be mailed to each creditor and other person adversely affected. In the case of a major city this would involve a printing and mailing bill of substantial size, particularly if amendments of the plan are made during the course of the proceeding.

For these and other reasons the present Chapter IX, while it may well be adequate for smaller municipalities, is simply not serviceable to handle the bankruptcy of a city approaching the size of New York. I turn, then, to an examination of the type of new legislation which is required.

A threshold question which the Administration carefully considered in formulating the present bill is whether, at the present time, we should seek amendment of the existing Chapter IX, or rather add an entirely new chapter to the Bankruptcy Act, for use only by major municipalities. Some of the deficiencies in the current law which I have described above impair its use by small cities as well as large—though the degree of impairment is much less. Nonetheless, it seems to us for a number of reasons that at the present time a separate chapter, available as an alternative to Chapter IX for major municipalities, would be

desirable. First, there are some features which we think are essential for large cities though not for small—for example, a requirement which I will discuss in due course that there be specific State authorization for the particular bankruptcy. Second, it is obvious that we are all considering the present legislation under some time constraints, since the necessity for its use by one of our major cities may arise within a short period of time.

Although much sound and helpful work has been done during the last few years on a proposed revision of Chapter IX, it seems to us unnecessary, in the present circumstances, to ask the Congress to devote immediate and expedited attention to that larger issue rather than focusing on the somewhat narrower but still difficult problem of major municipalities alone. Finally, a separate chapter for major municipalities seems to us desirable because it enables—or enables with greater assurance of constitutional validity—more substantial use of Federal judicial authority in overseeing reestablishment of the fiscal integrity of the petitioning city. As you know, an earlier Supreme Court decision whose continuing vitality is somewhat uncertain struck down as unconstitutional a municipal bankruptcy statute on the ground that it constituted a Federal intrusion upon State sovereignty which the bankruptcy power of the Constitution did not permit. *Ashton* v. *Cameron County Water Improvement District*, 298 U.S. 513 (1936). Later municipal bankruptcy legislation has been upheld only because, under it, "the State retains control of its fiscal affairs." *United States* v. *Bekins*, 304 U.S. 27, 51 (1938). It is unclear precisely what this means, and what actions of a bankruptcy court would violate this condition. If the present legislation is limited only to major municipalities, Federal intervention in the State's affairs can solidly be based not only upon the bankruptcy power but upon the commerce clause as well.

The latter, of course, has been held to justify substantial limitation upon State sovereignty, even to the point of establishing minimum wages for State employees. *Maryland* v. *Wirtz*, 392 U.S. 183 (1966). Realistically, the present high concern for the problems of New York City is attributable not merely to the fact that it is a city serving a large number of our citizens but also to the fact that its insolvency without the protection of a bankruptcy proceeding might seriously disrupt banking, financial and commercial activities nationwide. The same cannot be said of the insolvency of a small municipality. By limiting the present bill to major cities, therefore, the Congress can properly assert the commerce clause as an additional basis for its actions and thus, I am convinced, substantially increase the receptivity of the Supreme Court to judicial enforcement of budgetary limitations which the city may agree to as a condition of judicial approval of debt certificates or as a term of the final plan of adjustment with its creditors.

Let me now provide a brief overview of how this bankruptcy legislation would operate. A city desiring to proceed under the new Chapter XVI would file a petition stating that it is insolvent or unable to pay its debts as they mature, and that it desires to work out an adjustment of debts with its creditors. The petition would have to be accompanied by three documents: (1) As complete a list as is feasible of the claims outstanding against the city and of persons who may be adversely affected by the proposed plan of adjustment; (2) a good-faith plan of adjustment, setting forth precisely how it is that the petitioner proposes to settle its debts with its creditors; and (3) a statement of the city's current and projected revenues and expenditures, adequate to establish that the budget of the city will be in balance within a reasonable time after the plan as proposed is adopted.

On the filing of the petition and these three documents, there will be an automatic stay of suits and other enforcement actions by creditors, which will continue until the proceeding is terminated or the court removes it. Within the breathing space provided by this stay, the city would endeavor to obtain agreement by its creditors to the plan of adjustment it has proposed. The plan may be amended as necessary to obtain consent. It may provide for full payment of the debts over an extended period of time, or a compromise for less than the full amount due, or a combination of both.

While the city is negotiating with its creditors and trying to work out an agreement, the city would remain under the management of its mayor (or other person or body provided by State law); essential governmental functions would continue, since the court would have no power to interfere with such activities. Moreover, since, even if it is operating in the black, the city might have need to borrow funds during the pendency of the bankruptcy proceeding (in order to offset the fact that its tax revenues are seasonal while its expenditures are

constant), the city would be authorized to issue debt certificates, with approval of the court, which would have priority over other creditors. We anticipate, of course, that the court would not grant such approval unless the borrowing was for essential governmental purposes and unless the court was satisfied that the city was taking all feasible steps to place its fiscal affairs on a sound basis.

After the city has had an opportunity to discuss and negotiate its plan of adjustment with its creditors, a final proposal would be sent to all creditors wishing to receive it for their vote of approval or disapproval. The plan would not be confirmed by the court unless each class materially and adversely affected approved it by vote of two-thirds in amount of those members of the class who actually voted. However, the mere fact that a particular class does not grant such approval will not necessarily frustrate the plan, since a class will not be considered to be "materially and adversely affected" if provision is made for payment to it of the fair value of its claim. (Of course the fair value of a claim against an insolvent debtor is not necessarily the face value of the claim.) This is the so-called "cram down" provision, which prevents any class from vetoing a plan of adjustment.

If the requisite approval of the creditors is obtained, the court would certify the plan only if it makes a number of other findings, including a finding that the plan is fair, equitable, feasible and not unfairly discriminatory in favor of any creditor or class of creditors, and a finding that on the basis of petitioner's current and projected revenues and expenditures the budget of the petitioner will be in balance within a reasonable time after adoption of the plan. Of course there would be opportunity for creditors to contest these issues before the court. If, however, the plan is approved, it would be binding on all persons, and all debts of the city dealt with by the plan would be eliminated except to the extent the plan preserves them. The city would be obliged to abide by the plan, and the court would retain jurisdiction for as long as it felt necessary to assure that objective.

Mr. Chairman, I am sure that you and the Members of the Subcommittee have observed that the vast majority of the provisions contained in this legislative proposal are not new. They are derived either from the current provisions of Chapter IX or other chapters of the Bankruptcy Act, or from the carefully considered proposals for revision of Chapter IX developed by the Commission on the Bankruptcy Laws of the United States authorized by the Congress in 1970 and a Committee of Bankruptcy Judges. (These last two studies form the basis of legislative proposals now pending in the House—H.R. 31 and H.R. 32, respectively.) I would like to discuss briefly a few important provisions which do not track current law or pending proposals.

First, the bill contains in Subsection 803(a) the requirement that the municipality be specifically authorized by the State to file the proceeding. This is intended to mean not merely a general authorization for all cities, or even for the particular city, to file in bankruptcy, but a specific authorization for the particular filing that is made. The purpose of this provision is quite simple: It seems to us that the bankruptcy of a municipality of the size covered by the bill, which would involve a major segment of the human and material resources of the State, should require specific, particularized State agreement to the commencement of the proceeding. The matter is of such consequence to the State that a general authorization at an earlier time, by an earlier legislature, should not suffice. In addition to being dictated by fairness to the State, this provision is probably necessary for the ultimate effectiveness of the proceeding. The reestablishment of such a large city upon a sound fiscal basis can hardly be achieved without the wholehearted consent and support of the State authorities.

The bill departs from the existing recommendations for revision of Chapter IX in requiring a plan of adjustment to be filed with the city's petition (though, unlike the present Chapter IX, it would not require that plan to have advance approval of creditors). Subsection 804(b). This provision has several purposes. First, together with the statement of revenues and expenditures which I will discuss shortly, it performs the useful function of serving notice at the outset to all concerned parties—creditors, taxpayers, municipal employees—that the successful cure represented by the bankruptcy proceeding will require the taking of some strong medicine. The sooner recognition of that fact is established, the better it will be. Second, it will ensure that the city is in earnest about a plan of adjustment, and is not using the bankruptcy process merely in order to obtain a temporary defense against the claims of its creditors. Finally—and again together with the statement of revenues and expenditures—by clearly establishing

the intentions of the city, it will increase public confidence and thus enhance the marketability of the certificates of indebtedness envisioned by Section 811.

It is in my view not a valid objection to this provision that it is impracticable. Obtaining prior consent to a plan, as the current Chapter IX requires, is indeed an impossible task for a major municipality. But drawing up a good-faith plan which is fair, equitable and feasible is not. The debt structure of municipalities is quite simple as compared to that of major corporations, and it seems to me highly unlikely that a fully adequate plan could not be developed within a short period of time. Another possible objection to this provision is the assertion that its principal purpose can easily be avoided by the filing of a plan that is not at all likely of acceptance. Protection against this possibility is afforded by Section 806, which enables any creditor to file a complaint against a plan and permits the court to dismiss a plan upon finding that it was not filed in good faith or that there is no substantial likelihood that the court will approve it. This provision would render the risk of a frivolous plan not worth the taking.

A third provision differing from current law and pending proposals is the requirement of Subsection 804(b) for the filing with the petition of "a statement of petitioner's current and projected revenues and expenditures adequate to establish that the budget of petitioner will be in balance within a reasonable time after adoption of the plan." The purpose of this should be plain: The remedy which we are seeking to provide will have been useless if it merely enables a city to avoid paying some of its existing debts and then to return to its old ways, guaranteeing the recurrence of the crisis. The filing of this statement, and the requirement that the court find, before it approves the final plan, that the budget of the petitioner will be in balance within a reasonable time (Subsection 816(d)(7)), are intended to ensure that the objective of not merely protecting the city, but also reestablishing its fiscal integrity, will be achieved.

The provision of Subsection 812(2), giving priority to debts for services and materials actually provided within four months before the date of filing of the petition, is intended to enable the basic functioning of a city which may appear to be close to insolvency to continue, unaffected by the fears of employees, contractors, and suppliers that they will not be paid. Persons holding claims for personal services or materials are typically those who can least afford loss of income. It seems to us not unreasonable to give these prior claims treatment different from that accorded to the general category of creditors in the proceeding, which will consist almost entirely of holders of bonds and short-term indebtedness.

Finally, the provision for voting of creditors, contained in Subsection 814(a), is midway between the provision of the current chapter (which requires the affirmative vote of two-thirds in amount of each class) and the provision recommended by the Commission on the Bankruptcy Laws and the Committee of Bankruptcy Judges (which would require only 51 percent in amount of each class). What we suggest is two-thirds in amount of all members of each class actually voting. This, it seems to us, would avoid impairing the marketability of large city securities (which a 51 percent requirement might do) while at the same time solving the major problem caused by the fact that the creditors of a large city are so numerous and scattered.

There are, Mr. Chairman, other features of the bill I might discuss, but I will leave them for coverage in the question-and-answer period. I believe I have touched upon the principal provisions which can be considered distinctive. For the rest, I have distributed to you and all Members of the Subcommittee a Section-by-Section Analysis of the bill.

In closing, I would like to emphasize the President's strong personal interest in this legslation as the responsible way for the Federal Government to assist New York City in overcoming its financial difficulties. We are grateful to the Subcommittee for the prompt consideration it has accorded the President's proposal, and will be happy to provide whatever assistance we can to its further deliberations.

SECTION-BY-SECTION ANALYSIS

The existing Bankruptcy Act of 1898, as amended, contains in Chapter IX provisions to handle bankruptcy proceedings involving municipalities. For several reasons, these are inadequate to handle the bankruptcy of a major city. The present bill does not modify the provisions of Chapter IX, but adds a new Chapter XVI to the Bankruptcy Act, for use by major municipalities as an alternative to Chapter IX.

Jurisdiction and Reservation of Powers

Subsection 801(a) of the bill provides that proceedings under Chapter XVI are within the subject of bankruptcies and gives the court receiving a petition broad power to deal with the resulting proceedings. Compare Section 81 of the Bankruptcy Act, 11 U.S.C. 401. Original jurisdiction is provided for the composition and extension of debts under this Chapter.

Subsection 801(b) reserves to the states the power to control public agencies of the states. Such a reservation is desirable to avoid questions of the constitutionality of the proceedings. See *Ashton* v. *Cameron County Improvement District*, 298 U.S. 518. This follows the language of Section 83(i) of the Bankruptcy Act, 11 U.S.C. 403(i).

Definitions

Section 802 contains definitions to avoid the repetitious use of language throughout the bill and to clarify the meaning of terms used.

Eligibility for Relief

Subsection 803(a) provides that any municipality with a population in excess of 1,000,000 inhabitants is eligible for relief under this Chapter if the petitioner is first specifically authorized by the State to file a petition under this Chapter.

Subsection 803(b) would permit any public agency, instrumentality or political subdivision subordinate to the municipality, or whose responsibiilties are restricted to the geographical limits of the municipality, for whole debts the municipality is not otherwise liable, to file a petition for debt relief in the same proceeding. While separate plans of debt adjustment would be required, the bankruptcies would be treated simultaneously, before the same judge. This is desirable to enable overall consideration of the problems of all local governmental entities which may be affected by the bankruptcy of a major city, but which are legally autonomous.

Petition; Proposed Plan and Statement of Revenues and Expenditures; Filing

Section 804(a) requires the petitioner to recite that it is eligible to file a petition under this Chapter, that it is insolvent or unable to pay its debts as they mature and that it desires to effect a plan of composition or extension of its debts. The requirement of Chapter IX of the current law, that the petitioner have the acceptances of 51% of the creditors to the terms of a proposed plan as a condition of filing, is eliminated, since a major municipality could rarely if ever qualify on such terms. The petitioner must file with the petition lists of creditors and of persons who may be adversely affected by the proposed plan. If it is impossible to file complete lists Section 809 permits a general description of the claims, to be supplemented at a later time. Compare in part Section 8–202 of the proposal of the Commission on the Bankruptcy Laws, H. Doc. 93–137, Part II.

Subsection 804(b) requires the submission of a good faith plan of composition or extension which meets standard criteria for such plans. The petitioner must also submit a budget projection, showing that it will adjust its fiscal affairs to live within its means. If the requirements of this Subsection are not met, the petition will be insufficient to invoke the jurisdiction of the court.

Subsequent 804(c) specifies the court in which the petition should be filed and requires the petition to be accompanied by the payment of the filing fee. Compare Section 83(a) of the Bankruptcy Act, 11 U.S.C. 403(a).

Stay of Procedures

Section 805, derived from proposed Chapter IX Bankruptcy Rule 9–4, provides for an automatic stay of creditor actions, offsets and lien enforcement proceedings. Relief can be obtained from the stay as provided in Subsection (c). Obtaining other stays would require the showing specified in Rule 65 of the Federal Rules of Civil Procedure as modified by Subsection (d). If an automatic stay were not provided for, essential governmental services might be seriously interrupted by creditors' actions. Subsection (e) is correlated with Section 811 and Subsection 818(d). Aside from the court authority which the petitioner agrees to in obtaining the benefits of borrowing with court-sanctioned debt certificates, and the court authority to enforce the final plan of composition or extension which the petitioner agrees to, no court would interfere with the political or governmental powers of the petitioner. See the explanation of Subsection 801(b).

Contest and Dismissal of Petition

Subsection 806(a) would permit any creditor to contest the petition as therein provided. Compare Section 8–203 of H. Doc. 93–137, Part II. Subsection (b) would permit the dismissal of the petition under appropriate circumstances.

Notices

Section 807 covers notice requirements. Such notices are to be given by the clerk of court in the manner directed by the court. Both the State and SEC would be notified in order that necessary State actions can be taken and the public interest may be protected. In order to reduce the great expense and burden of giving all creditors notice of every possible matter in which they could conceivably have an interest, Subsection (d) permits the court, after issuance of an appropriate order, to suspend all or some notices to those who do not specify an interest in receiving them. Compare proposed Chapter IX Bankruptcy Rule 9–14(e).

Representation of Creditors

Section 808, dealing with the details of representing creditors in the proceeding, is derived from Section 83(a) of the Bankruptcy Act, 11 U.S.C. 403(a).

List of Claims and Persons Adversely Affected

Section 809 describes the contents of the list of claims which must be filed under Subsection 804(a). If some creditors cannot be identified, the reasons why identification is not practical will have to be given together with a characterization of the claims involved. If the lists filed with the petition cannot be complete, they can be supplemented as specified by the court. The court could modify the detail required in reporting of creditors claims and persons adversely affected.

Proofs of Claim

Section 810 governs the filing of proofs of claim. Unless there is objection by a party in interest, the claims listed by the petitioner as undisputed would be accepted as valid. This would substantially expedite the handling of these proceedings. Proof of claim for claims not listed or listed as disputed are to be filed by a date set by the court or, if no date is set, before the order of confirmation of the plan.

Debt Certificates

Section 811 is an important provision not found in existing law for the adjustment of debts of municipalities. Tax revenues are not collectible day by day, but are periodic. It is common practice for a municipality to make short-term borrowings, secured by anticipated tax revenues, to obtain operating funds until the tax receipts are available. By permitting the court to authorize the issuance of debt certificates on special terms, including priority over existing creditors, this necessary means of funding essential governmental services can be preserved. It is not intended that the court would use this authority to approve major construction projects or for matters which are not clearly of an essential governmental nature. To enhance the marketability of these debt certificates, the court is given exclusive jurisdiction over disputes involving their enforcement.

Priorities

Section 812 establishes priorities for the payment of certain claims. Compare Section 64a of the Bankruptcy Act, 11 U.S.C. 104a. In practice the first priority is observed already. Third priority claims currently are entitled to a first priority in municipal debt adjustment proceedings by virtue of 31 U.S.C. 191, subject to the practice of paying administration expenses first. The second priority is included to cover most prepetition debt claims of those rendering personal services or furnishing necessary supplies to the petitioner, often those least able to afford the loss or writedown of their claims.

Plan of Adjustment

Section 813 includes standard language concerning the provisions of a plan for debt adjustment. See the third paragraph of Section 83(a) of the Bankruptcy Act, 11 U.S.C. 403(a).

Voting on Acceptance of Plan

Subsection 814(a) requires the affirmative vote of two-thirds in amount of each class of claims for confirmation of a plan, unless a particular class is provided for as set forth in the proviso to the Subsection. Compare Section 83(d) of the Bankruptcy Act, 11 U.S.C. 403(d). Subsection (c), governing the division of creditors into classes, is taken from the proviso to the second paragraph of Section 83(b) of the Bankruptcy Act, 11 U.S.C. 403(b). Under Subsection (b) claims listed pursuant to Subsections 804(a) and 809(a) or for which proofs of claim have been filed pursuant to Section 810 may be voted except to the extent

claims have been disallowed. Claims owned, held or controlled by the petitioner are disqualified from voting, as in existing law. Also, Subsection (a) limits voting to creditors whose claims are materially and adversely affected by the proposed plan. Subsection (d) assures fairness in resolving disputes over whether particular claims are in fact materially and adversely affected.

The two-thirds vote requirement of existing law is not reduced in Subsection (a), in order to avoid making municipal bankruptcy too easy. This could have a drastic effect on the marketability of municipal bonds and the cost of borrowing money by municipalities. However, under the present bill the two-thirds requirement is computed not on the basis of two-thirds of all eligible to vote, but on the basis of two-thirds of those eligible who have in fact voted. It would be impossible for most major municipalities to obtain the required majority without this reasonable limitation. Security holders are too widely dispersed and may not choose to vote even when they know of the proceedings.

The "cram down" called for by the proviso to Subsection (a) is comparable to Subsection 8–302(b) of H. Doc. 93–137, Part II. The valuation of claims for purpose of "cram down" would require a considered estimate based on a proper factual foundation of the estimated revenues of the municipality. *Kelley* v. *Everglades Drainage District*, 319 U.S. 415. Consideration would also have to be given to non-income producing assets of the municipality which could appropriately be made to yield income or which, if currently not used, could be sold.

Modification of Plan

Section 815, governing modification of the plan, is taken from existing law. See the fourth paragraph of Subsection 83(e) of the Bankruptcy Act, 11 U.S.C 403(e).

Hearing on Confirmation of Plan

The language of Subsections 816(a) and (b) are derived in part from Section 8–307 of H. Doc. 93–137, Part II. Subsection (c) is adapted from language in the first paragraph of Subsection 83(e) of the Bankruptcy Act, 11 U.S.C. setting forth the findings and conclusions which the court must make before approving the plan, is adapted from the second paragraph of Subsection 83(e) of the present Act with the addition of protective language in Item (7) to assure that petitioner is making the adjustments necessary to achieve fiscal responsibility. If this is not done, the petition is to be dismissed.

Effect of Confirmation

Subsection 817(a) contains a necessary provision for the binding effect of an approved plan. Subsection (b) provides for the discharge or extinguishment of claims affected by the approved plan other than those excepted from discharge by the plan itself. The language of Section 817 is substantially the same as that recommended by the Commission on the Bankruptcy Laws. See Section 8–308 of H. Doc. 93–137, Part II.

Duty of Petitioner and Distribution Under the Plan

Section 818, governing the duties of the petitioner under the plan and distributions which are to be made thereunder, is derived in substantive part from Section 8–309 of the legislative proposal of the Commission on the Bankruptcy Laws.

Retention of Jurisdiction

Section 819 permits the court to retain jurisdiction to insure proper execution of the plan. However, the court may terminate jurisdiction at an earlier date if it is satisfied that the plan of composition or extension will be satisfactorily completed.

Reference of Issues and Compensation

Section 820, permitting the refernce of fact issues to a special master and governing the allowance of reasonable compensation, is derived in substantial part from existing law. See the third and fourth paragraphs of Section 83(b) of the Bankruptcy Act, 11 U.S.C. 403(b).

Separability

Section 821 provides for separability in the event any portion of this chapter or its application is held invalid. Compare the proviso to Section 81 in existing law, 11 U.S.C. 401.

STATEMENT OF ANTONIN SCALIA, ASSISTANT ATTORNEY GENERAL, OFFICE OF LEGAL COUNSEL, DEPARTMENT OF JUSTICE; ACCOMPANIED BY ROBERT GERARD, DEPUTY ASSISTANT SECRETARY, DEPARTMENT OF THE TREASURY, AND RUSSELL CHAPIN, CHIEF, GENERAL CLAIMS SECTION, CIVIL DIVISION, DEPARTMENT OF JUSTICE

Mr. Scalia. Thank you, Mr. Chairman.

I am pleased to appear with Mr. Gerard, who is seated to your left, and Mr. Chapin, who is seated to your right, at the subcommittee's request to discuss the administration's bill to add a new chapter to the Bankruptcy Act dealing with the adjustment of debts of major municipalities.

None of us happily considers the prospect of any large city's being unable to meet its financial obligations. Recent events with respect to the city of New York strongly suggest, however, that it is essential to have laws in place which can handle such an occurrence. Chapter IX of the Bankruptcy Act, now available to all municipalities, is in a number of respects inadequate for very large cities.

A feasible bankruptcy proceeding is vital, since it is the one means of enabling the functioning of a city to continue in an orderly fashion while an adjustment of its debts is negotiated with its creditors. The indispensable effect of a proceeding is to permit a stay of all legal actions, in both State and Federal courts, and a stay of private self-help remedies, such as the setoff by banks of the value of their claims against city payroll funds on deposit, which could have the effect of throwing the city into disorder.

The provisions of chapter IX of the Bankruptcy Act prevent a municipal bankruptcy proceeding from being commenced, and a stay from being entered, until the city has submitted to the court a plan of adjustment which already has the approval of 51 percent of its creditors. A preliminary stay may be obtained if the city can certify that it is seeking such 51-percent approval and has "a reasonable prospect of * * * acceptance within a reasonable time." In the case, for example, of a city of 1 million or more in population, with the volume and dispersal of debt obligations which such size would normally entail, merely locating a majority of creditors within a short period of time—much less obtaining the requisite approval or "reasonable prospect" of such approval—would be a formidable, and probably an impossible, task. For this reason alone, some alteration of the present provisions for large cities is essential.

There are, moreover, other respects, less crucial but nonetheless important, in which the existing law is inappropriate for major municipal bankruptcy.

The notice provisions of chapter IX are extraordinarily cumbersome when large numbers of creditors, many of whom may have relatively insubstantial interests in the proceedings, are involved. The mere expense of providing written notice in all cases would be enormously wasteful.

Any city of major size may have a number of incorporated authorities, commissions and districts which, though subordinate to it, are financially independent in the sense that the city is not liable for their debts. Likewise, some State-created governmental entities may operate

within the city's limits. Some of these units, either because they receive financial income from the city, or because they are affected by the general disruption which the city's insolvency causes, may be rendered insolvent at the same time. The present law contains no explicit provision which would enable the bankruptcy of all of these entities to be handled concurrently in a single proceeding, rather than individually by separate judges.

Chapter IX requires the plan of adjustment, before it can be accepted by the court, to be approved by two-thirds in amount of each class of creditors. Since, as noted above, in the case of a very large city many of these creditors may be either unreachable or uninterested in voting, the two-thirds requirement may realistically amount to 80 percent of those voting.

Chapter IX requires written proof of each claim by each creditor. The paper burden, in the case of a major city, would be enormous.

The same is true of chapter IX's requirement that the terms of the plan itself be mailed to each creditor and other person adversely affected. In the case of a major city, this would involve a printing and mailing bill of substantial size, particularly if amendments of the plan are made during the course of the proceeding.

For these and other reasons, the present chapter IX, while it may well be adequate for smaller municipalities, is simply not serviceable to handle the bankruptcy of a city approaching the size of New York. I turn, then, to an examination of the type of new legislation which is required.

A threshold question which the administration carefully considered in formulating the present bill is whether, at the present time, we should seek amendment of the existing chapter IX, or rather add an entirely new chapter to the Bankruptcy Act, for use only by major municipalities. Some of the deficiencies in the current law which I have described above impair its use by small cities as well as large—though the degree of impairment is much less. Nonetheless, it seems to us for a number of reasons that at the present time a separate chapter, available as an alternative to chapter IX for major municipalities, would be desirable.

First, there are some features which we think are essential for large cities though not for small—for example, a requirement which I will discuss in due course that there be specific State authorization for the particular bankruptcy. Second, it is obvious that we are all considering the present legislation under some time constraints, since, as Senator Hruska already noted, the necessity for its use by one of our major cities may arise within a short period of time. Although much sound and helpful work has been done during the last few years on a proposed revision of chapter IX, it seems to us unnecessary, in the present circumstances, to ask the Congress to devote immediate and expedited attention to that larger issue rather than focusing on the somewhat narrower but still difficult problem of major municipalities alone.

Finally, a separate chapter for major municipalities seems to us desirable because it enables—or enables with greater assurance of constitutional validity—more substantial use of Federal judicial authority in overseeing reestablishment of the fiscal integrity of the petitioning city. As you know, an earlier Supreme Court decision whose continuing vitality is somewhat uncertain struck down as

unconstitutional a municipal bankruptcy statute on the ground that it constituted a Federal intrusion upon State sovereignty which the bankruptcy power of the Constitution did not permit. *Ashton* v. *Cameron County Water Improvement District*, 298 U.S. 513 (1936).

Later municipal bankruptcy legislation has been upheld only because, under it, "the State retains control of its fiscal affairs." *United States* v. *Bekins*, 304 U.S. 27, 51 (1938). It is unclear precisely what this means, and what actions of a bankruptcy court would violate this condition. If the present legislation is limited only to major municipalities, Federal intervention in the State's affairs can solidly be based not only upon the bankruptcy power but upon the commerce clause as well. The latter, of course, has been held to justify substantial limitation upon State sovereignty, even to the point of establishing minimum wages for State employees. *Maryland* v. *Wirtz*, 392 U.S. 183 (1966). Realistically, the present high concern for the problems of New York City is attributable not merely to the fact that it is a city serving a large number of our citizens but also to the fact that its insolvency without the protection of a bankruptcy proceeding might seriously disrupt banking, financial and commercial activities nationwide. The same cannot be said of the insolvency of a small municipality. By limiting the present bill to major cities, therefore, the Congress can properly assert the commerce clause as an additional basis for its actions and thus, I am convinced, substantially increase the receptivity of the Supreme Court to judicial enforcement of budgetary limitations which the city may agree to as a condition of judicial approval of debt certificates or as a term of the final plan of adjustment with its creditors.

Let me now provide a brief overview of how this bankruptcy legislation would operate. A city desiring to proceed under the new chapter XVI would file a petition stating that it is insolvent or unable to pay its debts as they mature, and that it desires to work out an adjustment of its debts with its creditors. The petition would have to be accompanied by three documents: (1) As complete a list as is feasible of the claims outstanding against the city and of persons who may be adversely affected by the proposed plan of adjustment; (2) a good-faith plan of adjustment, setting forth precisely how it is that the petitioner proposes to settle its debts with its creditors; and (3) a statement of the city's current and projected revenues and expenditures, adequate to establish that the budget of the city will be in balance within a reasonable time after the plan as proposed is adopted.

On the filing of the petition and these three documents, there will be an automatic stay of suits and other enforcement actions by creditors, which will continue until the proceeding is terminated or the court removes it. Within the breathing space provided by this stay, the city would endeavor to obtain agreement by its creditors to the plan of adjustment it has proposed. The plan may be amended as necessary to obtain consent. It may provide for full payment of the debts over an extended preiod of time, or a compromise for less than the full amount due, or a combination of both.

While the city is negotiating with its creditors and trying to work out an agreement, the city would remain under the management of its mayor (or other person or body provided by State law, essential governmental functions would continue, since the court would have no

power to interfere with such activities. Moreover, since, even if it is operating in the black, the city might have need to borrow funds during the pendency of the bankruptcy proceeding (in order to offset the fact that its tax revenues are seasonal while its expenditures are constant, the city would be authorized to issue debt certificates, with approval of the court, which would have priority over other creditors. We anticipate, of course, that the court would not grant such approval unless the borrowing was for essential governmental purposes and unless the court was satisfied that the city was taking all feasible steps to place its fiscal affairs on a sound basis.

After the city has had an opportunity to discuss and negotiate its plan of adjustment with it creditors, a final proposal would be sent to all creditors wishing to receive it for their vote of approval or disapproval. The plan would not be confirmed by the court unless each class materially and adversely affected approved it by vote of two-thirds in amount of those members of the class who actually voted. However, the mere fact that a particular class does not grant such approval will not necessarily frustrate the plan, since a class will not be considered to be "materially and adversely affected" if provision is made for payment to it of the fair value of its claim. Of course, the fair value of a claim against an insolvent debtor is not necessarily the face value of the claim. This is the so-called "cram down" provision, which prevents any class from vetoing a plan of adjustment.

If the requisite approval of the creditors is obtained, the court would certify the plan only if it makes a number of other findings, including a finding that the plan is fair, equitable, feasible and not unfairly discriminatory in favor of any creditor or class of creditors, and a finding that on the basis of petitioner's current and projected revenues and expenditures the budget of the petitioner will be in balance within a reasonable time after adoption of the plan. Of course, there would be opportunity for creditors to contest these issues before the court. If, however, the plan is approved, it would be binding on all persons, and all debts of the city dealt with by the plan would be eliminate except to the extent the plan preserves them. The city would be obliged to abide by the plan, and the court would retain jurisdiction for as long as it felt necessary to assure that objective.

Mr. Chairman, I am sure that you and the members of the subcommittee have observed that the vast majority of the provisions contained in this legislative proposal are not new. They are derived either from the current provisions of chapter IX or other chapters for the Bankruptcy Act, or from the carefully considered proposals for revision of chapter IX developed by the Commission on the Bankruptcy Laws of the United States authorized by the Congress in 1970 and a Committee of Bankruptcy Judges. These last two studies form the basis of legislative proposals now pending in the House—H.R. 31 and H.R. 32, respectively, and in the Senate, S. 236 and S. 235, respectively. I would like to discuss briefly a few important provisions which do not track current law or pending proposals.

First, the bill contains in subsection 803(a) the requirement that the municipality be specifically authorized by the State to file the proceeding. This is intended to mean not merely a general authorization for all cities, or even for the particular city, to file in bankruptcy, but a specific authorization for the particular filing that is made. The purpose of this

provision is quite simple. It seems to us that the bankruptcy of a municipality of the size covered by the bill, which would involve a major segment of the human and material resources of the State, should require specific, particularized State agreement to the commencement of the proceeding. The matter is of such consequence to the State that a general authorization at an earlier time, by an earlier legislature, should not suffice. In addition to being dictated by fairness to the State, this provision is probably necessary for the ultimate effectiveness of the proceeding. The reestablishment of such a large city upon a sound fiscal basis can hardly be achieved without the wholehearted consent and support of the State authorities.

The bill departs from the existing recommendations for revision of chapter IX in requiring a plan of adjustment to be filed with the city's petition (though, unlike the present chapter IX, it would not require that plan to have advance approval of creditors). Subsection 804(b). This provision has several purposes. First, together with the statement of revenues and expenditures which I will discuss shortly, it performs the useful function of serving notice at the outset to all concerned parties—creditors, taxpayers, municipal employees—that the successful cure represented by the bankruptcy proceeding will require the taking of some strong medicine. The sooner recognition of that fact is established, the better it will be. Second, it will insure that the city is in earnest about a plan of adjustment, and is not using the bankruptcy process merely in order to obtain a temporary defense against the claims of its creditors. Finally—and again together with the statement of revenue and expenditures—by clearly establishing the intentions of the city, it will increase public confidence and thus enhance the marketability of the certificates of indebtedness envisioned by section 811.

It is in my view not a valid objection to this provision that it is impracticable. Obtaining prior consent to a plan, as the current chapter IX requires, is indeed an impossible task for a major municipality, but this provision does not require the obtaining of prior consent. But drawing up a good-faith plan which is fair, equitable and feasible is not. The debt structure of municipalities is quite simple as compared to that of major corporations, and it seems to me highly unlikely that a fully adequate plan could not be developed within a short period of time. Another possible objection to this provision is the assertion that its principal purpose can easily be avoided by the filing of a plan that is not at all likely of acceptance. Protection against this possibility is afforded by section 806 which enables any creditor to file a complaint against a plan and permits the court to dismiss a plan upon finding that it was not filed in good faith or that there is no substantial likelihood that the court will approve it. This provision would render the risk of a frivolous plan not worth the taking.

A third provision differing from current law and pending proposals is the requirement of subsection 804(b) of the bill for the filing with the petition of "a statement of petitioner's current and projected revenues and expenditures adequate to establish that the budget of petitioner will be in balance within a reasonable time after adoption of the plan." The purpose of this should be plain. The remedy which we are seeking to provide will have been useless if it merely enables a city to avoid paying some of its existing debts and then to return to its old

ways, guaranteeing the recurrence of the crisis. The filing of this statement, and the requirement that the court find, before it approves the final plan, that the budget of the petitioner will be in balance within a reasonable time [subsection 816(d)(7)], are intended to insure that the objective of not merely protecting the city, but also reestablishing its fiscal integrity, will be achieved.

The provision of subsection 812(2), giving priority to debts for services and materials actually provided within 4 months before the date of filing of the petition, is intended to enable the basic functioning of a city which may appear to be close to insolvency to continue, unaffected by the fears of employees, contractors, and suppliers that they will not be paid. Persons holding claims for personal services or materials are typically those who can least afford loss of income. It seems to us not unreasonable to give these prior claims treatment different from that accorded to the general category of creditors in the proceeding, which will consist almost entirely of holders of bonds and short-term indebtedness.

Finally, the provision for voting of creditors, contained in subsection 814(a), is midway between the provision of the current chapter—which requires the affirmative vote of two-thirds in amount of each class—and the provision recommended by the Commission on the Bankruptcy Laws and the Committee of Bankruptcy Judges—which would require only 51 percent in amount of each class. What we suggest is two-thirds in amount of all members of each class actually voting. This, it seems to us, would avoid impairing the marketability of large city securities—which a 51 percent requirement might do—while at the same time solving the major problem caused by the fact that the creditors of a large city are so numerous and scattered.

There are, Mr. Chairman, other features of the bill I might discuss, but I will leave them for coverage in the question-and-answer period. I believe I have touched upon the principal provisions which can be considered distinctive. For the rest, I have distributed to you and all members of the subcommittee a section-by-section analysis of the bill.

In closing, I would like to emphasize the President's strong personal interest in this legislation as the responsible way for the Federal Government to assist New York City in overcoming its financial difficulties. We are grateful to the subcommittee for the prompt consideration it has accorded the President's proposal, and will be happy to provide whatever assistance we can to its further deliberations.

Senator BURDICK. Thank you very much for your statement this morning. You have made a valuable contribution to this problem.

I have a series of questions, not many. Is it advisable to provide two different municipal reorganization chapters which set forth different standards for cities of different size? I am referring in that question to the, maybe, constitutional problem. You have spoken to that in your statement. Would you care to elaborate on it?

Mr. SCALIA. The constitutional problem I referred to in my statement is the problem of the uncertainty which has enveloped all municipal bankruptcy legislation because of a rather difficult to understand series of Supreme Court decisions. At issue are two cases which, on their facts, do not seem particularly distinguishable, but in the first, the Court said the municipal bankruptcy law was not constitutional; and in the second, the Court said it was. According to the Court, the

distinction was based upon the fact that in the second case, the State remained in control of its affairs—although it is difficult to understand why it did so more in the second case than in the first.

As a result, there is some uncertainty as to just what measures can be taken by a bankruptcy court, in the course of administering a municipal bankruptcy. It is obviously desirable to remove as much of this uncertainty as possible. It is our view, Mr. Chairman, that that end can be assisted by adopting a separate chapter for large municipalities, because in the case of large municipalities, the Federal Government, by providing the bankruptcy remedy, would not merely be using its bankruptcy powers under the Constitution—which are the powers the Supreme Court said would not justify, in the first case, at least, the municipal bankruptcy legislation. Rather, when a large municipality is involved, the Federal Government would also be acting under its commerce clause powers. The commerce clause has been very liberally construed by the Supreme Court, and it is our view that the combination of the two would give greater assurance of validity to the actions which the Court might take in the municipal bankruptcy proceeding.

Senator Burdick. Why would not the commerce clause be equally applicable to a city of 100,000 as to those of a million?

Mr. Scalia. Well, the commerce clause, heaven knows, has been asserted to be applicable to some very tenuous connections with commerce. But the great advantage of reciting an effect upon commerce where the statute applies only to major municipalities is that the recital is not only technically, but actually, true, as I indicated in my testimony.

The real reason for our concern about New York is, in part, the same as our concern about Podunk. We do not like to see any city which serves any of our citizens in financial difficulty. New York is bigger, so there are more citizens involved, to be sure, and that heightens our concern. But I think what really places New York in a different category—and this is evident in many statements that have been made by the Congress, by the President, by the Mayor, by many people who have spoken out on this issue, the fact that the chaos that would be produced by a city of this size going into insolvency without the benefit of a bankruptcy proceeding would have a significant effect upon our national commercial activity. For that reason, I think the Supreme Court would likely see very clearly the commerce clause connection, and would be more inclined to allow some liberality in the actions which the Federal judge can take in the course of the bankruptcy.

Senator Hruska. Mr. Chairman, would you yield for a question on this particular point?

Senator Burdick. Certainly.

Senator Hruska. Mr. Witness.

Mr. Scalia. Yes, Senator Hruska.

Senator Hruska. Does the bill contain an express provision, constituting a finding by the Congress that would invoke the commerce clause? Normally, we find a recital of findings of that kind at the beginning of the bill. I did not find it here. Can you refer me to the section where it is found?

Mr. Scalia. It is not contained in the bill. I think it would be a useful prologue to the legislation to recite a few whereases concerning the

considerations that prompt the legislation, and I think one of those should be a commerce clause consideration.

Senator HRUSKA. Could you suggest some language at a later time?

Mr. SCALIA. Yes, sir, I can.

Sentor HRUSKA. Would you get back to the committee on that subject?

Mr. SCALIA. I would be happy to.

Senator HRUSKA. Thank you.

Thank you, Mr. Chairman.

Senator BURDICK. As you and I know, the commerce clause has been stretched all over the lot. Is there anything in your suggestions, or in your recommendations here that would not apply equally to all cities?

Mr. SCALIA. There has been some indication, Senator, that the Supreme Court may finally be finding a line past which the commerce clause cannot go. I do not like relying upon a mere recitation of the commerce clause, where that is not the actual consideration involved. It is certainly less persuasive to the court to make such a recitation where it does not realistically comply with the facts.

Senator BURDICK. I understand that, but it also might be better than the Court eventually striking the bill down at some time.

Mr. SCALIA. Well, one can recite it and hope that they will be convinced by it and find it adequate. But my only point is, I think they are more likely to be convinced with respect to a bill that handles major municipalities the size of New York, Chicago, and so forth, than with respect to a bill that could handle a very small water district.

Senator BURDICK. Why is it necessary to require a city of over a million to establish that its budget will be in balance within a reasonable time after adopting a plan? This is not required of smaller cities, private corporations, or individuals who seek relief through the bankruptcy court.

Mr. SCALIA. Mr. Chairman, I think that provision in this legislation is necessary, but it may well be that it merely renders more explicit what would be a requirement in any bankruptcy. That is to say, it is difficult for a court to find that a plan is feasible—which the court invariably has to find in order to approve it—if the court knows that as soon as it lets go, and as soon as the plan goes into effect, the city is going to be insolvent again within a very short time and thus not able to comply with the plan. I think, however, that it is highly desirable to make that express in the present legislation, because in the case of a large municipality there will be some reticence on the part of the court to examine too closely the future proposed budgetary arrangements of the city.

Senator BURDICK. I am not finding any fault in your desirability. I am just asking—is there a logical distinction between a corporation, a small community, and a community or a municipality over a million?

Mr. SCALIA. No, sir. I am saying that there probably is not, and that such a requirement is probably applicable under present law in the case of a small municipality as well, because of the requirement that the judge must find a plan to be feasible before he approves it. That finds ing of feasibility would normally imply a judgment that the city is going to be back on its feet and operating all right. We just think it is desirable to make that point much more explicity when we are talking about major action of a Federal court in dealing with a large city.

Senator BURDICK. You see no difficulty with the fact that chapter X, chapter XI cases in smaller cities would not have to meet the same requirements?

Mr. SCALIA. Well, if you are referring to the single requirement of the budget, no, I do not. I think this requirement may permit, or indeed oblige the judge to get further into an examination of the budget than he might in the case of a small municipality, but I think the basic principle is the same in both cases. What we are trying to do is to make it very clear to the judge that he has a serious obligation under the statute to look closely into the future financial plans of the city.

As I say, I believe that in a small municipal bankruptcy under the present chapter IX, that would normally be done by a judge before he approves a plan anyway. The requirement that he do it is not explicit, but it is a much simpler task in such a case and perhaps you do not need express language for it.

Senator BURDICK. This leads me to another question that gives me some difficulty. You say on page 7 of your statement:

> The petition would have to be accompanied by three documents, one, as complete a list as is feasible of the claims outstanding against the city and of persons who may be adversely affected by the proposed plan of adjustment; two, a good faith plan of adjustment setting forth precisely how it is that the practitioner proposes to settle its debts with its creditors; and three, a statement of the city's current and projected revenues and expenditures adequate to establish that the budget of the city will be in balance within a reasonable time after the plan, as proposed, is adopted.

Now, that is a requirement that is to be contained in the petition, and of course, that is a petition that gives jurisdiction to the court. My question is this, not the advisability or desirability, but what happens—suppose this petition is filed. Suppose then the bankruptcy court takes jurisdiction and some certificates of indebtedness, or debt certificates, as they are called, are issued by the bankruptcy judge that tide the city over its problems. Then suppose some creditor comes in and attacks the plan, based on one of these three points. This is a jurisdictional matter. Suppose they find they have not presented a balanced budget. Now, would you then lose jurisdiction of the matter? And what would happen to the debt certificates?

Mr. SCALIA. If a creditor comes in and establishes that to the satisfaction of the court, the petition would be dismissed, but the court would retain jurisdiction over the debt certificates.

Senator BURDICK. No, no, because the petition that gives the court jurisdiction must have this established. That is in the petition.

Mr. SCALIA. You are assuming that the debt certificates have already been issued?

Senator BURDICK. Yes, that is right. You would not have this difficulty——

Mr. SCALIA. "Notwithstanding any other provision of law, including section 819 of this chapter, The Court shall have plenary jurisdiction of any action which may be brought against petitioner to enforce compliance with the terms of any such certificates of indebtedness." That is the last sentence of section 811, and the intention there is to indicate that even though the proceeding is either dismissed or completed the court would continue to have jurisdiction to enforce the certificates of indebtedness.

Senator BURDICK. My point is the petition itself gives the court jurisdiction, and if this petition is faulty, then the court does not have jurisdiction.

Mr. SCALIA. Well, I do not know how we could say it any more clearly, Senator, but that was our intention.

Senator BURDICK. You could say it by not requiring that in the petition, but requiring it in the plan. It is the petition that troubles me. Suppose some bondholder says, look, that does not present a balanced budget, and the court says, I think you are right; then you have destroyed the petition.

Mr. SCALIA. It is not clear that the validity of the petition is essential for the validity of the debt certificates which are issued under what is then a pending jurisdiction of the court that has not yet been ousted.

Senator BURDICK. But it is. The petition is necessary to give the court, jurisdiction, and then if the court does not have jurisdiction, you will find out later that any certificate that is issued in the meantime is without jurisdiction, is it not?

Mr. SCALIA. The lack of jurisdiction to adjudicate the bankruptcy does not necessarily mean that every action which the court takes during the period in which it appears it has jurisdiction is an invalid action.

Senator BURDICK. I do not know how any act can be valid without the jurisdiction.

Mr. SCALIA. I think a court has initially, of course, jurisdiction to determine jurisdiction, and certain actions it takes during that period may be valid. It seems to me jurisprudentially possible to provide that these certificates can be issued, and even if the petition should later be dismissed as being improperly brought, the certificates would continue to be valid. That is what section 811 intends to say.

Senator BURDICK. I know what its intention is. I am not finding a quarrel there, but suppose you did not require these three in the petition, but required them in the plan. At least we would have the court with jurisdiction, would we not?

Mr. SCALIA. Well, not if you require them in the plan, and the plan has to be filed with the petition, and the petition is invalid unless there is a proper plan filed with it. It seems to me you are still back in the same boat, unless you provide for filing the plan after the petition, and make it clear that the plan is not necessary for the court's jurisdiction.

Senator BURDICK. My question is posed to the debt certificate, at the time you pull the rug out from under them. That is what I was concerned about.

Mr. SCALIA. Well, it certainly is a matter to be concerned about. I do not mean to minimize the problem. If this is not clear on it or, as I do not believe, it is ineffective on it, it should be changed to make it absolutely certain that——

Senator BURDICK. Would you kind of mull that over in your mind until we meet again?

Mr. SCALIA. I certainly will; yes, sir.

Senator HRUSKA. Would the chairman yield for a question on that point?

Senator BURDICK. Yes.

Senator HRUSKA. Is not that same difficulty inherent in the issue of any municipal bond or any State bond? Suppose that a State enacts a law authorizing the issuance of bonds, and those bonds are issued and they are marketed, and then a challenge is leveled at the capacity of the legislature to authorize issuance of that bond. If that challenge is successful, what happens to the bonds, which, in the meantime, have been underwritten and sold to investors? Is that not an inherent problem in municipal funding of any kind, not only interim certificates of indebtedness, but in any kind of——

Mr. SCALIA. Yes, sir, I agree, and I would feel better if I knew what the result was, in the bond case.

Senator BURDICK. What happens to the bonds, in that case?

Senator HRUSKA. In some cases, those bonds are worthless.

Mr. SCALIA. Well, I think it is the same thing that would happen to these debt certificates, or it is likely to be the same thing.

Senator BURDICK. Let's think about bond indebtedness, in the meantime.

If a city is required to establish that a budget is balanced, is there a standard method of accounting, to give meaning to this requirement?

Mr. SCALIA. A standard method of accounting, so that in each case, the judge would have to apply certain criteria? It would certainly help, Mr. Chairman. I question whether it is feasible. I am given to understand that accounting practices vary enormously from city to city, and some of them are passing strange. To have to untangle the whole thing and set it up under a new accounting system, I think would be an enormous task and might protract the bankruptcy proceeding to a significant degree. It would, indeed, not only protract the proceeding, but if you require this statement to be filed going in, it would make it impossible for the city even to commence a proceeding until it somehow untangled its accounting system and put it together in a new fashion. So what you suggest is desirable, but I think you would have to inquire into its feasibility before proposing its addition to this bill.

Senator BURDICK. I think you have spoken to why you removed the requirement that 51 percent of the creditors approve a plan of reorganization before a plan could be adopted. You would go to two-thirds of those present and voting. I presume that means those voting by proxy too?

Mr. SCALIA. Yes; it would include those voting by proxy.

Senator BURDICK. Well, the question that bothers me is, many of these bondholders are held—when you talk about numbers—by institutions, in a great number. What do you do about a case that give those who have a great number of bonds a veto power, as well as approval power over a plan?

Mr. SCALIA. Well, of course, the existing law has a two-thirds requirement as it is. Of course, you can presume that the big investors vote, while some of the little ones do not. So the distinctive effect of the present bill, as contrasted with existing law, is not to give large investors a greater veto power, but a greater approval power, since those that do not vote, presumably small investors, would no longer be counted as voting no.

It seems to me that this is a better disposition than the existing Municipal Bankruptcy Act. I think, moreover, that in the case of

large municipalities, the problem of vast proportions of the shares being accumulated by a few investors is probably less likely to exist than it is in the case of a small municipality which may make, as you know, a sale of a substantial portion of its issue to a few investors.

Senator BURDICK. If the large bondholders voted no, it would be very hard for the small ones to vote yes on that basis, would it not?

Mr. SCALIA. Yes, sir; I think that is the case whenever you adopt a majority voting requirement.

Senator BURDICK. So those who advocated 51 percent—there would be less veto power than the 66⅔ percent?

Mr. SCALIA. Yes, sir. I suppose the other side of it is that if you have a 51-percent requirement, one large bondholder might be able to put you into it—might be willing to accept the plan; whereas, with two-thirds, it takes a lot more. It cuts both ways, it seems to me.

Senator BURDICK. I understand that. I do not know which way is best, either, but I am pointing out that it is not all one way.

Mr. SCALIA. Yes, sir. The present law has not proved unsatisfactory, in our view, in this respect, except for the fact that it does not, in the case of large cities, take account of the fact that many bondholders will not vote at all. To count those votes as noes does not make much sense.

Senator BURDICK. We could take care of that by saying 51 percent of those voting, instead of two-thirds of the ——

Mr. SCALIA. Yes, sir. But that would really impair, it seems to me, the attractiveness of municipal bonds of the large cities, because that means that a relatively few number of large investors can require the acceptance of a plan.

Senator BURDICK. Maybe there is more merit in requiring a larger percentage for a veto. I think the balance lies on that side.

Mr. SCALIA. I do not think that is right; the reason being that if your friends, the large shareholders—you are a little shareholder—if your friends the large shareholders put you into a plan, it could be a very disadvantageous one. Whereas if they keep you out of a plan, you are assured of getting the fair value of your claim under the cram down provision of the statute.

So you are not harmed if a relatively small number of large investors can keep you out of a plan. You are still going to get the fair value of your claim. If, however, a small number of them can take you into a plan, all you are assured of getting is the plan, with the court determination that it is fair and equitable—which is somewhat less than court assurance that you are getting the fair value of your claim.

Senator HRUSKA. Would the chairman yield for a question?

Senator BURDICK. Yes.

Senator HRUSKA. What applicability has a cram down provision in this case? How would it work? Is this the place where it would be applied?

Mr. SCALIA. Yes, sir. Whenever the city cannot obtain from a particular class the necessary majority, two-thirds of all those voting, the city has two choices: Either No. 1, it has to abandon the bankruptcy proceeding, or, No. 2, it has to pay off that class of creditors,

not in full, but the fair value of their claims which would be decided by the court.

Ordinarily, it would be more attractive to the class to negotiate something with the city than to take their chances as to what the judge is going to say is the fair value of their claims.

Senator HRUSKA. The existence of the cram down provision, therefore, tempers somewhat the possibilty or the potential of a veto, does it not?

Mr. SCALIA. Indeed, it does.

Senator HRUSKA. And that again, is that contained in chapter IX?

Mr. SCALIA. I frankly do not recall, Mr. Chairman, whether it does or does not have a cram down. Mr. Chapin advises me that it has one which is not as clear as the normal cram down provision is. May I let him field that one?

Senator HRUSKA. May I ask, then, what is the history? What are the precedents of the cram-down provision?

Such a concept exists, what is the history of it? What are the precedents on it? Can you inform us on that either now or in a later memorandum?

Mr. SCALIA. It is nothing new in bankruptcy law, of course. It exists under other chapters, as well. We can provide that to you.

Senator HRUSKA. Thank you, Mr. Chairman.

Senator BURDICK. I am going to give you an easy one now.

Section 804(c) provides that a petition will be filed with the court to induce territory jurisdiction in the municipality in major part wherever it is located.

That would mean the case would be filed in Brooklyn, would it not?

Mr. SCALIA. It means it would be filed in the southern district of New York.

[Editor's note: See Mr. Scalia's supplemental statement.]

Senator BURDICK. Would you please illustrate by example in what circumstances 805(e) would be applied?

Mr. SCALIA. Excuse me, you said (b)?

Senator BURDICK. (e), I said (e).

Mr. SCALIA. Well, 805(e) is, of course, an acceptance of the principles of federalism and also a nod to the somewhat confusing Supreme Court cases that I discussed earlier. What it means, essentially, is that the judge does not take over the running of the city. As I indicated in my testimony, the mayor, or whatever authority the state has placed in control of the city, continues to run it. The court's influence over what the city may do exists only because the court may obtain the city's voluntary agreement to certain actions in order to obtain debt certificates or in order to get the plan approved as being a feasible plan and one that will result in a fiscally sound city budget.

But the judge has no authority by reason of the proceeding to say you do this, you do not do that, and this is how the city runs. He obtains that authority only because the city voluntarily agrees to certain of these actions in order to obtain measures that it wants from the court or to get a certain type of plan finally approved by the court.

Senator BURDICK. But, per se, it does not interrupt the usual function of the city during the period of the administration of the bankruptcy?

Mr. SCALIA. That is correct.

Senator BURDICK. Section 811 provides that debt certificates can be issued upon good cause being shown.

I am wondering if we are going to have any trouble with that phrase, "good cause."

Mr. SCALIA. I do not think so, Mr. Chairman.

We are dealing with a city that is already insolvent. Now, obviously, the city should not be going further into debt for some frivolous purpose. It has to be a very important governmental purpose that is involved. And that is what constitutes "good cause shown." I do not think the phrase gives any trouble. In fact, if it were not there, I am sure the court would behave the same way.

Senator BURDICK. In other words, you will invest the bankruptcy judge with that discretion?

Mr. SCALIA. Yes, sir; I think that is entirely reasonable.

Senator HRUSKA. Would you yield for a question on that point, Mr. Chairman?

Priority is accorded such certificates of indebtedness. Now, suppose a series of certificates of indebtedness are authorized by the court and they are issued in April of a given year, and then things get really hard, and in October he issues another order authorizing a further issue of another series of certificates of indebtedness, would it be within the power of the court to put the priority of the second series ahead of the first series?

Mr. SCALIA. No, sir; I do not believe it would.

The way this is normally done—well, the basic purpose of it, as I indicated in my testimony, is to enable an evening out of expenditures and revenues. Normally, what will happen is that the income from specific taxes will be devoted, and specified by the court to be devoted, to the payment of particular certificates of indebtedness.

Senator HRUSKA. And would they be considered preempted to the point that they could not be imposed upon by a later series of certificates of indebtedness?

Mr. SCALIA. Yes, sir; I believe that would be the case.

Senator HRUSKA. That would bear heavily, would it not, upon the marketability of these certificates?

Mr. SCALIA. It certainly would.

Senator HRUSKA. In the first instance or in the second.

Mr. SCALIA. Or both.

Senator HRUSKA. Thank you.

Senator BURDICK. But you are still relying upon the discretion of the judge, are you not?

Mr. SCALIA. Yes, sir.

Senator BURDICK. Do you intend to give debt certificates priority over other administrative expenses?

Mr. SCALIA. Yes, sir; as far as the revenues which are devoted to those certificates are concerned.

Senator BURDICK. You would give them No. 1 priority?

Mr. SCALIA. Yes, sir.

Mr. GERARD. Mr. Chairman, could I just add something to that? It is related to something that Senator Hruska implied.

You never reached the question, in my view, of whether a debt certificate will—payment of a debt certificate—will interfere with payment of a payroll or payment of a vendor, because as a practical matter, debt certificates will not be marketable in amounts greater than the sur-

plus in the city's cash flow at a later period. So no one will purchase a debt certificate if the only source of repayment would involve a dipping into the payroll or some other fund for essential services at a later time.

Mr. SCALIA. Mr. Chairman, I think I had better add your last question to the list of things that I should clarify for the committee.

I am frankly not clear about what the experience of debt certificates has been, as compared with administrative expenses of a city. I am not sure the case has ever arisen in which certificates of indebtedness have been issued and then somehow the city reaches such a pass that fire and police protection cannot be afforded because the debt certificates have to be paid off. That should not happen; I doubt whether I will find a case in which it has happened. But I frankly am not very confident that if it should happen, the police and firemen are going to be paid second. That does not seem like the right answer to me.

Let me do what further research I can on it.

Senator BURDICK. And give us your further views on that, if you will.

You may do it in writing, if you wish.

Mr. SCALIA. Yes, sir.

Senator BURDICK. As you will on other matters that we refer to.

Mr. SCALIA. Yes, sir.

Senator BURDICK. As long as you are on that subject, do you intend to give the debt certificates priority over secured and unsecured applications?

Mr. SCALIA. Existing, you mean? You mean the ones that exist?

Certainly. Yes, sir.

Senator BURDICK. President Ford in his address to the National Press Club stated:

> In the event of default, the Federal Government will work with the court to assure that police and fire and other essential services for the protection of life and property in New York are maintained.

This harks back to what you have already referred to.

> Further, the act has provided that the Federal Government will work with the court to provide essential services in the event of default.

Again, part of the same question.

But maybe you could answer it further.

Mr. SCALIA. It is not provided in the act. I think that was President Ford's assurance as Chief Executive. It contemplates, among other things, doing whatever can be done to expedite Federal payments due to the city under general revenue sharing or anything else, and making sure that those Federal programs that can assist the city are devoted to the largest extent posible to that end.

Senator BURDICK. Shouldn't we have some reference to it in the act?

Mr. SCALIA. I do not think it is necessary, Senator.

Once again, whereas President Ford's statement was made in the context of the particular city that we are concerned about today, the act applies not just to this city but to all cities over a million, and not just to the current problems but problems in the future. Whether, having enacted this statute, the Federal Government will be as well disposed in the future, is perhaps a matter that ought best to be left for the future.

Let us assume that New York City goes into bankruptcy, and the Federal Government does bend over backward to provide every assistance. Then New York City comes out and goes in again within a few years. It may well be that all of us would not smile upon bending over backward to accelerate Federal programs to the city and to provide whatever assistance is possible when, by that time, we have some reason to believe that the money will just be wasted. It seems to me it is best left to a case-by-case determination rather than put in a statute as a requirement that the Federal Government do thus and so.

Moreover, even if it were put in the statute, I do not know how it could be expressed. The Federal Government would do everything possible to help the city. I do not think you could be terribly specific. It depends upon what programs are pending, what programs have available funds, and so forth.

Senator BURDICK. I am not finding any fault with the President's statement. I am just wondering, is there any further protection we give the essential services to take care of it. That is what I am wondering.

Do you think the act covers it well enough?

Mr. SCALIA. I think the act enables the Federal Government to do whatever it cares to do to help the city, and I think in the ordinary case, as in the present case, the Federal Government will do everything that it can to help the city. I do not think there is any need to promise it beforehand. And, indeed, if one did promise it, the promise would be so vague as not really to be enforceable, anyway.

Senator BURDICK. Would it be advisable to provide for a modification of the plan after confirmation of the plan as is presently provided for in chapter X?

In other words, suppose there is an agreement on a plan A, and then 2 weeks later they figured plan B would be better. Is there anything in your bill to prevent the amendment of the plan?

Mr. SCALIA. No, sir, in fact, the bill contemplates modification.

For instance, in section 807(a), concerning notices, it says that persons are entitled to request a copy of the plan of modification. It refers to modification specifically.

Section 815 is an entire section dealing with modification of the plan.

Thus, we do provide for it, and indeed it is very likely that there would have to be at least one modification. That is obviously desirable.

Senator BURDICK. On section 815 of the act, it states: "Before a plan is confirmed, changes and modifications may be made therein with the approval of the judge after hearing" and so forth.

We are talking about changes after the plan is confirmed. Is there a change in the language there?

Mr. SCALIA. I am sorry. Was your question whether the plan can be modified after confirmation?

Senator BURDICK. Yes; that was the question.

Mr. SCALIA. Excuse me, I did not understand.

Frankly, in the context of municipal bankruptcy, and particularly in the context of bankruptcy of large municipalities, I do not think that would be a good provision, because one of the purposes of the bankruptcy proceeding is to induce the city to take stern measures that are necessary to pull itself out of the hole, measures which have

largely been rendered impossible in the past because of political considerations.

If there is a substantial hole in what the court adopts so that the city is free to come back in and ask for changes, I am concerned that the city will not make every effort as it must to fulfill its commitments and to get its house back in order. I think that is the risk one runs by saying the plan can be modified. It is almost an open invitation to all of the interests that got the city in the shape it was in in the first place to continue their pressures to get it back there again.

Senator BURDICK. In other words, the contracts were made, let us see how it works and not change it right away?

Mr. SCALIA. Yes, sir.

Senator BURDICK. Do you believe that the court should have the power to cancel labor contracts or person plans where it determines they are too burdensome for the State?

Mr. SCALIA. Well; no, sir. It is never a question of the power of the court to cancel them. The court under this proposal does not run the city and does not direct anything to be done.

The city can offer to renegotiate contracts, to do whatever it thinks is necessary and reasonable to put its house in order. It would be a voluntary action by the city presented to the court, and the court could approve that action if it considered it reasonable.

Senator BURDICK. You are saying it is the city's responsibility to present its plan for solvency?

Mr. SCALIA. That is correct. All the court does is make them live up to what they promise and nothing more.

Senator HRUSKA. In close connection with labor contracts, of course, there are certain investment pension rights that are outstanding and others that are in the process of being formulated.

Can a bankruptcy plan affect the pension rights of employees, either potential and in the making or those who have already invested?

Mr. SCALIA. It is my understnding—and Mr. Gerard can help me on this one—that most of these pension plans which one reads about in the case of New York are fully funded. That money is not within the control of the city anymore. It has been paid and is now in the control of the trustee of the pension plans.

So recalling those pension rights is not something that the city can do. That is the equivalent of the city's going back to people it has already paid and getting them to return the money.

Senator HRUSKA. As I understand it, those pension plans were not contributed to by employees.

Am I incorrect?

Mr. SCALIA. The employees do not contribute. But it is my understanding that the city does contribute. And when I say contribute, I mean contribute. This money is paid. It is no longer the city's money.

Senator HRUSKA. We can make inquiry on that.

I just wonder—it has been suggested by some people that some of those pension plans are somewhat injudicious however actuarily sound they might be.

Mr. SCALIA. If we are talking about the payments that the city is contractually obligated to make in the future under existing employment arrangements, they can certainly be altered or renegotiated, if that is what the city proposes.

But as to moneys that have already been paid to establish the pensions of people that are already entitled to them, it is my clear understanding that that money is gone. It is no longer the city's money. It is as though the city had given the people cash and they have gone out and spent it. It cannot be returned under a bankruptcy proceeding.

Senator HRUSKA. I can understand there is a difference between a fact accomplished and a fact which is now set in motion, but there is a third class, is there not? Suppose the period of retirement is 20 years, and an employee has been there 10 years, what about that? That is something that is partially accomplished and partially prospective.

Mr. SCALIA. Yes, sir, and I suppose the city could say that—if it can renegotiate the contracts—in the future it will not pay this much money each year into the trust fund which, when you retire, will pay you so much a year, but, as to the moneys already paid in the past, they are already in there and you will be entitled to the interest from that.

Senator HRUSKA. Mr. Chairman, you have asked so many fine questions here, not all of them are easy ones, and some of them are quite perplexing and difficult, but you have gone into many of the points in which I would also like to go. It might be that there is duplication; if so, resort to that prerogative that a witness has, by saying, Senator, that question has already been asked and answered, and this Senator will give you benefit of the doubt, if any exists.

Mr. SCALIA. All right, sir.

Senator HRUSKA. But, for the purpose of developing a record, I will propound some of these questions, but, while they might be duplicative, nevertheless they might serve a purpose, and they might be duplicative of some of the statements you made in your original statement.

Mr. SCALIA. That is fine, Senator.

Senator HRUSKA. Item 1. The bill requires that a plan of composition or extension must be filed with the petition. However, in general, the bill follows a policy of allowing the court maximum flexibility in administering the proceeding. As a practical matter, would it be more in keeping with the principle of flexibility if the bill provided that the plan should be filed with the petition, or as soon thereafter as the court, by order, would require?

Mr. SCALIA. That would undoubtedly create more flexibility in the proceeding, but there are some matters as to which we do not think flexibility is as desirable as others. One thing we feel strongly about is that when this proceeding commences, the city go into it with a will; that it not just be temporizing for the purpose of staving off creditors and meanwhile not even giving any serious thought to what it proposes to do to put itself back in shape; but that it go into the bankruptcy with a clear plan in mind, having made the resolve to take the stern measures that have to be taken. It is for that reason we think the plan should be submitted immediately with the petition.

As earlier discussion showed, there is provision for modifying the plan, but we think it is reasonable at least to require the city to have something concrete in mind when it comes in.

Senator HRUSKA. Now, as I understand the bill, a Federal district judge would conduct the chapter proceedings. What policy considerations were taken into account in choosing a Federal district judge over a judge of a bankruptcy court?

Mr. SCALIA. Obviously, Senator, as this discussion has shown, there is an enormous amount of discretion on the part of the judge in this proceeding—more, I think, than in most proceedings—and the matter he is dealing with is incomparably more important than the matters which would be dealt with in most proceedings in bankruptcy. For those reasons, we think it is important that we do whatever can be done to insure that the best possible person handle the case.

Without meaning to in any way criticize bankruptcy judges, United States district judges are, ex officio, by reason of their stature, by reason of their lifetime tenure, presumably better qualified to take on a job of this magnitude.

Senator HRUSKA. The bill does prohibit, does it not, general reference?

Mr. SCALIA. Yes, sir.

Senator HRUSKA. But it does permit specific reference of an isolated issue, an isolated situation, which some finding of fact might be found desirable?

Mr. SCALIA. Yes, sir, and some of those issues may be very difficult ones; but what cannot be done is simply to delegate the entire case to a bankruptcy judge.

Senator HRUSKA. Now, the bill would not allow the court to interfere with "any of the property or revenues of the petitioner necessary for essential Government purposes." Is the phrase, essential Government purposes, defined in the bill? Would there be any difficulty in that?

Mr. SCALIA. It is not defined. There is, of course, difficulty in the sense that it is not a very specific phrase. I do not know what could be done to render it more specific. It is another one of those matters that has to be left to the sound judgment of the court.

Senator HRUSKA. And, if a purpose is challenged, the court would have hearings, arguments and make a decision?

Mr. SCALIA. I think that is correct.

Senator HRUSKA. And do the best he can on a case-by-case basis?

Mr. SCALIA. Yes, sir.

Senator HRUSKA. Now, the bill, of course, provides that a municipality must be specifically authorized by State law to file the petition under this chapter. It also, provides that an agency, or political subdivision of the municipality, may file a petition, if it is not prohibited to do so by State law. Should not the agency or political subdivision, for constitutional considerations, if not other consideration, be required to obtain affirmative consent from the State like the municipality proper is required to do?

Mr. SCALIA. Senator, I think it would be constitutional so long as it used the language "Not prohibited"—even in the case of the large cities. Indeed, that is the proposal of the Commission on Bankruptcy Laws for their proposed new chapter IX, that any municipal petition can be filed if it is not prohibited by the State.

So, we think that that provision as applied to the subunits within the city is constitutional. It is arguably constitutional for the city

itself, but we do not think it is a good idea for the city itself, simply because, as I indicated in my testimony, the city is so important to the State that we ought to be sure the State goes along.

Senator HRUSKA. The bill would allow a priority for the materials actually provided to the city within 4 months of the filing of the petition. What policy considerations underlie this provision which, of course, gives priority to unsecured creditors over bondholders and other secured creditors?

Mr. SCALIA. Yes, sir. I think the principal policy underlying it is that when you are dealing with the precarious financial condition of an enormously large city, you do not want to create a situation—by reason of a bankruptcy statute that the city can now use—in which during the months in which the city is approaching insolvency, people suddenly begin to withdraw their services or to withhold goods that are necessary for the city's essential functioning. In other words, you do not want to precipitate a bankruptcy if you can avoid it. This provision enables at least the bulk of the services and goods that the city needs on a day-to-day basis to continue to be provided with confidence by the city's employees and the city's small suppliers.

As I stated in my testimony, there is a certain equity in treating these people differently as well. By and large, they cannot afford having their claims against the city knocked down. It is not as though they are investing money which they have lying about. In the case of city employees, it is their salary you are talking about; in the case of a small supplier, it is his day-to-day business you are talking about.

For both of those reasons, we think it is a reasonable provision.

Senator HRUSKA. There are two aspects to it, of course. The priority granted to materials and to services——

Mr. SCALIA. Yes.

Senator HRUSKA. Would it be well to consider, or was it considered, that priority with reference to services be provided only to city employees rather than to others?

Mr. SCALIA. Which would eliminate consultants and so forth?

Senator HRUSKA. Contract employees, for example.

Mr. SCALIA. Contract employees?

It seems to me that services very important to the city, personal services very important to the city, may be provided by persons other than employees. And it seems to me that the justification for the special treatment is just as strong in both cases.

Senator HRUSKA. Now, banks who may be depositors of the city may also be bondholders?

Mr. SCALIA. Yes, sir.

Senator HRUSKA. Setoff by the bank of deposits against the amount due on the bonds will automatically be stayed by the filing of the petition in this bill. Can the plan of composition or extension provide that no set-offs will be allowed and that the city will be able to use the deposits for payment of the claims of all creditors?

Mr. SCALIA. Yes, it certainly can. But personally I would find it hard to consider that to be a good faith plan. I think the city coming in with something that extreme would be running a serious risk of having its proceeding dismissed. It is a possible proposal, but it is not at all a likely outcome.

Senator HRUSKA. The general rule without that express provision in the bill, would be that a setoff would be permitted, would it not?

Mr. SCALIA. Yes, without the stay, a setoff would normally be permitted.

Senator HRUSKA. Because of the fact that there is a debtor/creditor relationship.

Mr. SCALIA. I think that is right.

Senator HRUSKA. The bill requires for filing and confirmation that "the budget of the petitioner will be in balance within a reasonable time after adoption of the plan."

What is a balancing of the budget?

What is a balanced budget?

Would that give trouble to the people that will have to make that decision, whether or not that status has been achieved?

Mr. SCALIA. Senator, taking advantage of your offer, that question has already been answered—or not answered, as the case may be. It is awfully difficult to say what is a balanced budget. It is one of those matters that is going to have to be determined by the judge, and there are sound accounting principles that can be followed. There are probably alternative sound accounting principles that can be followed, and it will be up to the judge to figure it out.

The same thing applies to the phrase "reasonable time."

Senator HRUSKA. You have covered somewhat the idea that chapter IX should stay as it is and chapter XVI would apply to cities of a million or more and so on. If you have any additional thoughts on that, on the relative merits of one as against the other, or of making it applicable generally to all municipalities, it might be well to submit a supplemental memorandum on that. I think you covered it pretty well.

That will be one of the points that we probably will engage in during a conference on the bill of the other body, as opposed to a bill that would provide, as your proposal does—

Mr. SCALIA. Yes, sir. I think I have nothing more to say about it. As you recall, our points on that issue are three: First, that we think there are some features that are peculiarly useful for large municipalities, such as the requirement of specific prior consent. I would not put that in a bill for small municipalities. Our second point is that we think it would strengthen the constitutionality of the legislation and, I think, give the judge who is handling the case further assurance in dealing with the matter before him. And the third and last point is really one which I cannot assess nearly as well as you can. That is, that given the timeframe within which this legislation, if it is to be useful for the immediate purpose that we are concerned about, must be passed, Congress would find it easier to concentrate its attention upon the more limited factual situation of a big city rather than trying to come up with something that would apply across the board.

Senator HRUSKA. Mr. Chairman, that is all the questions I have.

Thank you for your very clear and lucid explanation of a very difficult subject.

Mr. SCALIA. Thank you, Senator.

Senator BURDICK. When you send in further information, do not forget to touch on that subject, whether it would be inimical to the interests of the smaller cities to be included in the bill.

Mr. SCALIA. Yes, sir. I will specifically address that.

Senator BURDICK. Thank you.

Mr. SCALIA. Thank you, Mr. Chairman.

[Supplemental statement of Antonin Scalia, Assistant Attorney General follows:]

DEPARTMENT OF JUSTICE,
Washington, D.C., January 16, 1976.

Hon. QUENTIN N. BURDICK,
Chairman, Subcommittee on Improvements in Judicial Machinery, Judiciary Committee, U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: During the course of my testimony before the Subcommittee on Improvements in Judicial Machinery on the President's proposal for the enactment of a Chapter XVI of the Bankruptcy Act dealing with major municipalities, I was asked to supply the answers to certain questions for the record. I am glad to supplement my testimony as requested. The answers to the questions raised during the hearing are contained in the attachment to this letter.

I would like to take this opportunity to correct an error in my testimony: As a former New Yorker, I should be charged with knowledge that the major part of the City's area lies in the Eastern District of New York rather than, as I stated, the Southern District.

I greatly appreciate the speed with which the Chairman scheduled hearings on this important legislative proposal and the prompt and effective response of the Subcommittee to the needs of these times. If we can be of further assistance to the Subcommittee on this matter, please let me know.

Sincerely,

ANTONIN SCALIA,
Assistant Attorney General, Office of Legal Counsel.

Enclosure.

RESPONSES TO QUESTIONS POSED TO ASSISTANT ATTORNEY GENERAL ANTONIN SCALIA

1. Would it be desirable for the legislation to contain congressional findings which support factually the validity of basing the legislation upon the Commerce Clause of the Constitution of the United States?

Such findings would certainly not be inappropriate, but we do not consider them necessary. As indicated in my testimony, the facts concerning the direct effect which the activities of major municipalities have on interstate and foreign commerce are so clear that a case for constitutionality based on the Commerce Clause can readily be established without express congressional findings.

A recent issue of the County and City Data Book compiled by the United States Bureau of Census shows that the six major cities which would be covered by the Administration's legislative proposal account for 23 percent of the Nation's receipts for selected services, 19 percent of the Nation's wholesale sales, 10 percent of its retail sales, 12 percent of the payroll for manufacturers of the Nation, and approximately 11 percent of the value added by manufacturers. More than 18½ million people live in these cities, and the population of their metropolitan areas exceeds 36½ million.

Clearly, if such cities were unable to invoke the Bankruptcy Act and obtain a stay of creditors' actions, the ensuing disruption of municipal services and thus municipal commerce would have a nationwide impact.

2. What would be the effect of Section 804 of the Administration's proposal on the validity of debt certificates issued with the approval of the court if there were to be a subsequent finding that the court lacked jurisdiction?

Since such certificates would be issued by the municipality, it seems clear that they would bind the municipality. It must be acknowledged as doubtful, however, whether they could be enforced with all of the priority and conditions established by the court order approving their issue, if the court should subsequently be found to have lacked jurisdiction. Of course, a court would presumably not approve such certificates if it had substantial doubts concerning its jurisdiction; and there is something to be said for putting some teeth into the jurisdictional prerequisites, so that the city's proceeding in apparently bad faith will impair its ability to obtain additional financing. Nonetheless, if the existence of any doubt as to the priority of the certificates of indebtedness is deemed unacceptable, the problem is easily solved by providing specifically that a subsequent determination of lack of jurisdiction will have no effect upon the validity of, and the court's power with respect to court approved certificates.

I may note that the Subcommittee's version of S. 2597 eliminates the problem in a more sweeping fashion, by removing entirely the jurisdictional requirements contained in Section 804(b) of the Administration's bill.

3. Would debt certificates issued with the approval of the court have priority over all administrative expenses, including those for essential city services?

We are aware of no court case which addresses this issue. In principle, under the proposed legislation such priority would be possible. It would depend, however, upon the terms of the certificates, which would of course have to be approved by the court. Moreover, even if such priority were written into the certificates with the court's approval, it is extremely unlikely that it would ever have to be used—for the simple reason that if the city's financial situation were so precarious as to render it conceivable that, even with the stay of payments on other indebtedness, administrative expenses for essential city services could not be met by current revenues, the debt certificates would not be marketable. That is to say, I believe no investor would accept any substantial risk—in dealing with a city that is already bankrupt—that he would be forced to assert a priority over essential governmental expenses.

4. Give a history of the "cram down" provision found in the proviso to Section 814(a) of the Administration's proposal.

The "cram down" provision in the Administration's bill was derived from the analogous provision of Chapter X on corporate reorganizations. See paras. (7) and (8) of Sec. 216 of the Bankruptcy Act. This provision was in turn derived from the Railroad Reorganization Provisions of the Bankruptcy Act. See Sec. 77B(b) (4) and (5). A discussion of this whole matter may be found in 6A Collier on Bankruptcy, ¶ 10.11 (14th ed.).

5. What added thoughts do you have on those features of the Administration's bill which would not be appropriate for a revised Chapter IX of the Bankruptcy Act, applicable to all municipalities rather than merely major cities?

First, we think the specific state authorization for the filing of a petition by a major municipality found in Section 803(a) of the Administration's bill is a requirement which is peculiarly appropriate for large cities. The six cities which would be eligible to file petitions under the Administration's bill account for 28 percent of the manufacturers' payroll for the states in which they are located, 25 percent of the value added by manufacturers, 24 percent of the retail sales, 43 percent of the value of selected services provided, and 39 percent of the wholesale sales. Given the fact these cities account for such a major portion of the economic resources of the states in which they are located, the states should have an active role in deciding whether the extraordinary step of bankruptcy should be taken. Indeed, it is doubtful whether any bankruptcy plan for a city of such size could succeed without active state support and cooperation. It is best to assure that sooner rather than later. In the case of a small municipality or a water district, on the other hand, the matter may be of such negligible interest to the state as a whole that obtaining affirmative state consent may be not merely unnecessary but, for all practical purposes, impossible.

Bankruptcies involving a major municipality are proceedings of national interest and impact. In our opinion they deserve the quality of judicial ability to be found in our United States District Courts. They require, moreover, the insulation from popular and political pressures which the judge of a constitutional court, with lifetime tenure, possesses. It would be unwise, however, to require district judges for all municipal bankruptcies, since most can be adequately handled by bankruptcy judges and district courts are already overburdened.

Because of the large number of small creditors having claims against a major municipality, it is reasonable—perhaps even essential—to provide, as does the Administration's proposal, for alteration of the required majority for approval from two-thirds in amount (the present law) to two-thirds in amount of those voting. Without this alteration, it could be enormously difficult, because of the failure of small creditors to participate in long and complicated proceedings, to obtain the necessary approval of a reasonable plan. It is not at all clear that this alteration is desirable with respect to smaller municipalities and water districts, whose debt structure is much more simple and less dispersed. There the need for facilitating approval may be outbalanced by the need to enhance the marketability of little-known securities.

The Department of Justice will be submitting written comments on current proposals for revision of the Bankruptcy Act, and in that submission we will provide further comment on provisions appropriate for what is now Chapter IX of the Act. We are concerned that if Chapter IX revision is selected as the means

of meeting the current financial crisis in New York, factors which are peculiar to that situation may color perceptions as to the provisions which should be contained in general bankruptcy law; and the time pressures applicable to the New York situation may deprive the more general subject of the full deliberation which it should be given.

Senator BURDICK. Our next witnesses will be Mr. Patchan and Mr. Countryman.

Welcome to the committee.

Joseph Patchan is a former bankruptcy judge, and he is now a practicing attorney in Cleveland.

Mr. Countryman is a professor of law at Harvard University.

Gentlemen, you may decide in which order you want to appear and go to it.

STATEMENT OF JOSEPH PATCHAN, FORMER BANKRUPTCY JUDGE, CLEVELAND, OHIO

Mr. PATCHAN. Thank you, Mr. Chairman.

Mr. Chairman, my name is Joseph Patchan. I am an attorney practicing in Cleveland, Ohio; a partner in the firm of Baker, Hosteter and Patterson, in my city. I have until recently served on the bankruptcy bench as a bankruptcy judge.

In addition to my law practice, I am on the adjunct faculties of the law school at Case Western Reserve University and Cleveland State University. I am also a member of the National Seminar Faculty for Bankruptcy Judges at the Federal Judicial Center, the instructional arm of the U.S. courts, located here in Washington.

I appreciate the opportunity to present to you, sir, and to the committee, my views as a practicing lawyer, specializing in bankruptcy and debt rehabilitation matters. I appear in my individual capacity at the invitation of the committee.

Mr. Chairman, a written statement of my remarks is not available. I would appreciate leave to submit my remarks for the record at a later date.

Senator BURDICKS. Could you make it within 10 days?

Mr. PATCHAN. I shall.

Senator BURDICK. Thank you.

[The prepared statement of Joseph Patchan follows:]

STATEMENT OF JOSEPH PATCHAN ON S. 2597

I. SUMMARY

S. 2597 is designed to fill the gap now apparent in bankruptcy law applicable to public debtors. Present law is not workable for large cities requiring pervasive restructuring.

But the bill fills the gap only in part.

Access to the court, a problem under present law, remains a problem. There is need to eliminate the requirement that a plan, a certification, and a budget be filed with the petition. These cloud administration of the case, for complaints directed to the initiating documents jeopardize the jurisdiction of the court.

There is need to prune the various reasons provided for dismissal of the case before it is concluded. The court should not lose or relinquish jurisdiction until a successful plan is produced.

Finally there is need to provide a mechanism to bring state and regional officials into the process. Their help may be necessary to deliver statehouse support where responsibility for some city functions are to be transferred out of the city.

This bill is limited to use by major cities of one million population or more. Chapter IX is intended to be available for smaller public debtors which, presumably, have "smaller" problems.

Rather than the possibility for successive chapters of the bankruptcy act for various populations, the size limitation should be omitted. The bankruptcy power granted by Art. I Sec. 8 cl. 4 of the Constitution is suffiicent for municipal bankruptcy. An updated chapter should be available to any public debtor with major debt problems.

II. BENEFICIAL FEATURES OF THE BILL

There are many beneficial features in the bill.

Sec. 805 provides for stay of proceedings, of setoffs, of counterclaims against debtor. The stay is automatically effective upon the filing of the petition. Currently, the stay is subject to the discretion of the court and is to be granted only after notice and hearing.

Except for burdening the clerk's office with the duty to give notices to parties, the notice provisions in Sec. 807 are good. Sec. 807(d) permits flexibility to accommodate needs of the case. The scope and clarity of this provision facilitates administration of the case.

Creditors who dissent from the plan are accommodated in Sec. 814(a). They would receive the value of their claims. Characterized as a "cram down" provision, it provides a viable substitute to acceptance of the plan. The provision wisely permits an alternative to cash payment.

The principal beneficial feature of the bill is embodied in the proposal to permit issuance of "debt certificates", Sec. 811. The "debt certificates" provided for in Sec. 811 are similar to the certificates of indebtedness long available to private debtors in other chapters of the bankruptcy act. The certificates are designed to raise cash for the ongoing needs of the city pending consummation of the plan. However, the marketability of these certicates will remain questionable as long as there is doubt about the court's jurisdiction. Under S. 2597 jurisdictional doubt will linger because challenges to jurisdiction may be raised throughout the administration of the case under Sec. 806(a).

The court is to be empowered to authorize issuance of the certificates upon a showing of good cause. This broad fiat is better limited to the needs of the city for purposes of public safety and public health. Such limitation would place the matter squarely within the police power. What indeed is needed for public safety and public health should be left to the city. The scope of public health and public safety may well vary with the circumstances of the debtor.

III. THE JURISDICTION OF THE COURT

The bill proposing Chapter XVI for the bankruptcy act does not adequately resolve the present problem of access to the court.

Presently, Chapter IX requires submission of the plan with the petition. Prior to filing the petition, the plan must have been accepted by 51% or more of affected creditors. This requirement may preclude major cities from filing a case in spite of their distress, because prepetition creditor acceptance is impossible to achieve. Moreover, the requirement does not adequately protect creditors holding bearer paper who are generally unknown to the city. Obtaining prepetition creditor acceptance may prevent a filing during a critical period. Further, both the debtor and its creditors are denied use of the court's processes in the formulation of the plan.

S. 2597 deletes the requirement that the plan must have been accepted by a majority of affected creditors prior to filing. In its place, the debtor is required to certify that the plan filed with the petition is, in the debtor's own view fair, equitable, feasible, and not unfairly discriminatory in favor of any creditor or class of creditors. Further, the debtor must supply financial figures "adequate to establish that the budget of petitioner will be in balance within a reasonable time after adoption of the plan." Sec. 804(b).

Past experience in requiring submission of plan with petition indicates that the requirement is not workable if a meaningful plan is expected. Accordingly, similar requirements in other chapters have been eliminated.

Certification, which supplies a self-serving, unilateral statement that the plan is fair, equitable, etc., benefits lawyers only. The "certification" called for in Sec. 804(b) will undoubtedly serve as an engine for litigation. Contests of the certification may be raised by any creditor and goes to the jurisdiction of the court. Secs. 804(b), 806.

Whether a plan is "fair, feasible, equitable," etc. is a judicial determination. Judicial determinations are rarely aided by self-serving conclusions made as a matter of form.

The requirements that a certified plan and a budget accompany the petition are burdensome baggage. They preclude access to the court. Indeed, they do not improve upon the access flaws perceived in Chapter IX. Additionally, since the validity of the plan and budget go to jurisdiction of the Court, the requirements jeopardize the entire case by threatening its jurisdictional foundation.

The design and purpose of the bill would be greatly enhanced if Sec. 804(b) is omitted.

IV. DISMISSAL OF THE CASE

The bill permits the court to dismiss the case if the petition was not filed in good faith, or does not meet the requirements of the chapter, or has not been prosecuted with reasonable diligence, or where "there is no substantial likelihood that a plan of composition will be approved by the court". Sec. 806(a).

These events of dismissal are apparently designed to cause debtor to measure up to the standards of the chapter and to proceed with dispatch. All to the good. But dismissal may be disastrous to a city. The threat and ready possibility of dismissal alters the negotiating balance to be maintained between the debtor and its creditors.

If anything, dismissal of the case should be precluded.

The court has means within its powers to maintain momentum of a case. It has means to order compliance with statutory requirements.

Certainly when the parties reach frustration in regard to a plan which has "no substantial likelihood" of approval by court, the case should remain in court. The posture of the court and its resources are most frequently needed when there is an impasse to aid in causing the parties to work together to formulate an appropriate plan.

Dismissal of the case and return to the streets should not be available until the case is successfully administered. It would seem that nothing less than a successful workout should be appropriate in any case filed under the chapter. Certainly it should be the only course for a major city with a million or more people.

V. NEEDS OF THE BILL

A. Appointment of Committee of Officials

A successful plan leading to a balanced budget may require the functional restructuring of the city's services. For example, the city may have reached the point where it can no longer carry a transit system, or municipal hospitals, or airport facilities. These functions cannot be discontinued. They can be maintained by larger taxing units as the state, county or regionally formed authorities. These entities may need state laws and perhaps state acceptance of responsibility.

The city cannot unilaterally plan for the shift of responsibilities. Neither can the court dictate the contents or the passage of enabling legislation.

The primary responsibility to formulate and present a plan should continue to rest upon the petitioner debtor. But where the debtor alone cannot design a workable plan or where functional restructuring is needed, the court should serve as a catalyst to bring necessary parties together to produce such a plan.

Appointment of a committee of officials, outside the debtor's own ambit, would give influential parties responsibility to come up with a viable plan and deliver state legislative support if necessary. The makeup of the committee should vary with the debtor's particular circumstances. Possibly, the Governor, speaker of the state legislature, others with state influence might be appointed.

The members of the committee would be publicly brought into the process of plan formulation and its delivery. By this means the debtor may have a plan which otherwise may be outside its own powers to fulfill.

B. Mandatory Retention of Jurisdiction

Sec. 819 of the bill allows the court to determine if it should retain jurisdiction of a proceeding to assure execution of the plan.

It should be made clear in the statute that the retention of jurisdiction applies to the post confirmation period.

Further, retention of jurisdiction should not be left to the discretion of the court. Retention of jurisdiction until substantial compliance with plan should be mandatory.

Unless there is mandatory retention of jurisdiction there is little assurance that succeeding city administrations will honor a demanding plan.

Additionally, the purpose of retention of jurisdiction should be enlarged to enable the debtor to return to court to modify a confirmed plan. If the plan turns out to be too onerous or changed circumstances permit its easing, the debtor should have ready means to return to court without the necessity of starting the entire process anew.

VI. CONCLUSION

Bankruptcy laws today do not adequately provide for a large city in financial distress. There is need for legislation to stop creditor action, to preclude bank setoffs, to authorize issuance of certificates of indebtedness to maintain essential services, and to satisfy dissenting creditors. These are supplied in the bill.

Certain provisions in the bill, however, need restructuring. Some should be deleted since they hinder the purpose of the bill. Some additional provisions are needed.

A feature of the bill empowers the court to authorize issuance of certificates of indebtedness. The certificates are intended to raise money to pay for essential services of the city. That purpose may be frustrated however, by other provisions in the bill permitting attack on the court's jurisdictions which damage marketability of the certificates.

The requirement that the petition be accompanied by the plan, plus a certification that the plan is "fair, feasible and equitable", plus a budget should be dropped. Deleted also should be the various means by which the case may be dismissed.

State and regional officials should be brought into responsible positions in the case. Their aid may be important if city functions are to be shifted to the state or regionally formed authorities.

S. 2597 is an improvement over present law. Its benefits should not be limited merely to the six largest cities in the nation. Smaller cities have major problems. They too need the availability of an updated statute.

OUTLINE OF MY PROFESSIONAL BACKGROUND JOSEPH PATCHAN, ATTORNEY AT LAW

Partner.—Baker, Hostetler & Patterson, 1956 Union Commerce Building, Cleveland, Ohio 44115.

Bankruptcy Judge.—U.S. District Court, Northern District of Ohio, Eastern Division, 1969–1975.

Adjunct Faculties.—Cleveland State University, Cleveland Marshall Law School, Cleveland, Ohio.

Case Western Reserve University, Thomas Backus School of Law, Cleveland, Ohio.

Member.—Natioanl Seminar Faculty for Bankruptcy Judges, Federal Judicial Center, Dolley Madison House, Washington, D.C.

Author.—Practice Comments to Bankruptcy Rules (Clark Boardman Pub.)

Contributor.—Herzog's Bankruptcy Forms and Practice (Clark Boardman Pub.), Nadler, The Law of Bankruptcy, 2nd Ed. (Harrison Co. Pub.), and Bankruptcy Judges Deskbook (Federal Judicial Center).

Mr. PATCHAN. Mr. Chairman, members of the committee, the present Bankruptcy Act does not adequately provide for large cities in financial distress. The bill to enable major municipalities to adjust indebtedness goes quite a distance to fill the gap now apparent in the law. It has many fine features. The notice provision is good. The stay provisions are good. The cram down provision is good. The proposal to permit issuance of debtors's certificates, I believe, is excellent; although in that provision I feel it should indicate that the limitation for issuance is to be for public safety and public health needs. It should be clear that the court can issue certificates after a petition is filed, and not have them be subject to the vagaries of a subsequent decision that the court may not have had jurisdiction.

However, the proposal for chapter XVI does not adequately resolve the present problem of the petitioner's access to the court. Indeed,

access is made more difficult. It seems incongruous to me that on the one hand the prepetition approval by 51 percent of creditors is removed, while on the other hand, the debtor must file a fully developed plan with his petition which it will certify is a fair, equitable and feasible, and not unfairly discriminatory among creditors.

In addition, he must file a statement to establish that the budget will be in balance within a reasonable time after adoption of the plan.

These are awfully high hurdles. They are made particularly demanding as their need comes at the very outset of the case. It requires a long view down an awfully long road to come up with accurate documents in these areas.

Nowhere else in the law does a petitioner, in order to get into court, have to certify to conclusions of law, such as fair, equitable, and feasible. He may certify certain facts, but certainly not these which are normally within the scope of judicial determinations.

The immediate need for a preformed plan precludes the orderly formulation of a plan. It would seem that a petitioner cannot truly certify its budget will be in balance where the plan depends on State or regional authorities to take over some city functions. You may not know at the outset whether or not they will take it over. All this has to be worked out under the aegis of the court.

Most disturbing to me is the ready availability of dismissal. The case may be dismissed for a number of reasons built into this bill. I submit that the court should be precluded from dismissing the case. The parties should be kept in court until the workable plan comes forth. Vital city services should be continued rather than throwing the city out of court and thereby refusing it relief.

The statute should provide a means for State or regional people, outside of the ambit of the city, to be brought into positions of responsibility for performance and perhaps, the formulation of a plan. This is particularly important where State or regional entities must assume certain city functions and new legislation may be required, out of the statehouse.

There is need too for assurance that a long-term plan will be lived up to, although city administrations change. This can be accomplished by a mandatory retention of jurisdiction. The bill leaves retention of jurisdiction up to the court.

Mr. Chairman, I have tried to hit a few of the salient points that have struck me in my reading of this bill. I do feel that here is an opportunity to take its many good parts and the many well drafted, well reasoned provisions and blend them with the massive work already done by this committee, by the Bankruptcy Commission, the Bankruptcy Judges and by the Bankruptcy Rules Comittee, to provide one workable chapter for public debtors be they large or small.

Small cities may have major problems, just as major cities may have small ones. And I feel that one well designed, amended chapter IX might accommodate both.

Mr. Chairman, I do appreciate the opportunity you have given me to be heard and I will be available to you to answer questions where I can.

Senator Burdick. Thank you very much.

Mr. Countryman?

STATEMENT OF VERN COUNTRYMAN, PROFESSOR OF LAW, HARVARD UNIVERSITY LAW SCHOOL, CAMBRIDGE, MASS.

Mr. Countryman. Mr. Chairman, probably the least serious suggestion I have to make is to state for the record that my first name is Vern, V-E-R-N, and not Vernon. I have been fighting a losing battle on that for 58 years, but I shall persist.

Mr. Chairman, I have taught bankruptcy law for 25 years in various law schools in the country. I am a vice-chairman of the National Bankruptcy Conference, a private organization of bankruptcy judges, bankruptcy practitioners, and bankruptcy lawyers, which has concerned itself with the improvement of our bankruptcy system since 1933.

I was a consultant to the Commission on the Bankruptcy Laws of the United States, which has produced one of the bills pending before you for a complete revision of the entire bankruptcy law.

Earlier I was a consultant to the Brookings Institution in its study of the bankruptcy system. But I do not speak today for any of those organizations, but solely for myself. I will attempt to keep my oral statement brief, but like Mr. Patchan, would appreciate an opportunity to submit a written statement within the next 10 days, as the Chairman suggested.

Senator Burdick. Without objection, so ordered.

[The prepared statement of Prof. Vern Countryman follows:]

Statement of Vern Countryman

As requested by the Chairman of the Subcommittee on Improvements in Judicial Machinery of the Senate Judiciary Committee at the hearings on S. 2597 on October 31, 1975, I submit the following written statement in elaboration and supplementation of my oral testimony.

I am a Professor of Law at Harvard Law School. I have taught bankruptcy and reorganization law since 1946 save for a four-year period, 1955–1959, when I practiced law in Washington, D.C. I am a vice-chairman of the National Bankruptcy Conference, a private organization of bankruptcy judges, practitioners, and law teachers formed in 1932 to work on proposed revisions of the Bankruptcy Act of 1898 which were enacted as the Chandler Act of 1938. Since that time the National Bankruptcy Conference has continued to concern itself with the improvement of the bankruptcy law.

I was a consultant to the Brookings Institution in its study of the bankruptcy system which led to a report published in 1971. Stanley and Girth, *Bankruptcy: Problem-Process-Reform*. I was also a consultant to the Commission on the Bankruptcy Laws of the United States whose 1973 report recommended a complete revision of the present Bankruptcy Act. H. Doc. No. 93–137 (1973). The Commission's recommendations are now pending before the Congress as S. 236 and H.R. 31. Competing recommendations of the National Conference of Bankruptcy Judges are also pending as S. 235 and H.R. 32. Both this subcommittee and the Subcommittee on Civil and Constitutional Rights of the House Judiciary Committee have held numerous hearings on these bills and more are scheduled. (To repeat what I earlier said orally, I do not now speak on behalf of any of the above organizations or institutions with which I was or am affiliated, but solely in my individual capacity).

Each of these bills contains a chapter—Chapter VIII of the Bankruptcy Commission's bill (S. 236 and H.R. 31) and Chapter IX of the Bankruptcy Judge's bill (S. 235 and H.R. 32)—which would replace present Chapter IX of the Bankruptcy Act in dealing with the adjustment of debts of public agencies and instrumentalities and political subdivisions, including municipalities. The scheme of each of these bills is to work this Chapter into the proposed new Bankruptcy Act as part of an integrated bankruptcy law whose provisions will be appropriately correlated with other provisons of that law.

The proposal embodied in the Ford Administration's S. 2597, the subject of these hearings, is not to disturb that scheme, but to enact a new Chapter XVI of the present Bankruptcy Act as an alternative to present Chapter IX which

presumably, is intended to survive as an alternative to any revision of present Chapter IX which might emerge as a consequence of the proposals for comprehensive revision of the entire Bankruptcy Act.

The alternative Chapter XVI would, under § 803(a) of S. 2597, be available only to municipalities with a population in excess of 1,000,000 inhabitants if the municipality is first specifically authorized by the state to file a petition initiating a case under Chapter XVI. Since we have only six cities with a population in excess of 1,000,000 [Statistical Abstract of the United States 23 (1974)] and since Chicago, Detroit, Houston, Los Angeles and Philadelphia are not currently in severe financial crisis, this formulation seems designed to provide a new procedure for the City of New York, as was made evident by President Ford's speech before the National Press Club on October 29 [New York Times, October 30, 1975, p. 46], the same day on which he transmitted his proposal to the House [H. Doc. No. 94–289] and two days before S. 2597 was introduced.

In any event, I question the wisdom of this proposed bifurcation of procedures under which one system of debt adjustment would be available to cities with more than 1,000,000 in population under Chapter XVI and another system would be available to other state agencies, instrumentalities, and political subdivisions—including the same large cities—under Chapter IX or its replacement. The President's message justifies this proposal "because of [unspecified] inadequacies of Chapter IX of the current Bankruptcy Act in its application to the problems of major municipalities" [H. Doc. No. 94–289, p. 1]. There are inadequacies in present Chapter IX which I will discuss below, but they are by no means confined to cities of more than 1,000,000 in population, as I shall also demonstrate below. Therefore, I submit that the proposal to limit the proposed new Chapter XVI to such cities is not based on the peculiar inadequacies of present Chapter IX in its application to such cities but represents an effort to tailor a special procedure to deal with the current financial crisis of the City of New York.

This seems to me to be an unsound approach to what is apparently intended to be a permanent part of our bankruptcy law, particularly in light of the requirement of Article I, §8, Clause 4 of the Constitution that laws on bankruptcy be "uniform . . . throughout the United States." A preferable approach, it seems to me, is to design a single new replacement Chapter for present Chapter IX which will be available to all state agencies, instrumentalities, and political subdivisions and which will cure the general inadequacies of present Chapter IX. If, in the process, any special inadequacies with respect to larger units or to any other types of units are disclosed—as they have not yet been—they may be dealt with in the drafting of the new single replacement.

Whether it is necessary also to extract this new, replacement Chapter from the proposals for comprehensive revision of the Bankruptcy Act and to rush it to enactment ahead of those proposals is, for me, a matter for considerable doubt. The alleged necessity is supposed to be based on the current financial crisis in the City of New York, but it is far from clear to me that the City would avail itself of the new Chapter if it were available. There seems to me to be considerable shadow-boxing going on between the Ford Administration with its bankruptcy proposal on the one side and Mayor Beame and Governor Carey, who profess no interest in bankruptcy, on the other side. Resolution of this question may, in any event, depend on decisions yet to be made by the City's major creditors—particularly the banks and the labor unions—and by the ultimate fate of proposals for federal guarantees now pending before the Banking Committees of each House. All I can say at this point is that the case for accelerated treatment of this subject has not yet been made and that if default should come to the City the present provisions of § 83(c) of Chapter IX provide a means for the City to obtain up to a 120-day stay of creditor action which would give the Congress more time to act than is apparently contemplated by the sponsors of S. 2597 for its enactment.

I turn now to a series of defects in S. 2597, many of which are merely carried over from present Chapter IX by undiscriminating copying of its provisions.

Section 801(b) of the bill perpetuates the provisions of § 83(i) of Chapter IX preserving the power of the state to control its municipalities and political subdivision "in the exercise of its political or governmental powers, including expenditures therefor." This provision was inserted in the 1937 drafting of what is now Chapter IX out of deference to the decision in *Ashton* v. *Cameron County Water District*, 298 U.S. 513 (1936), holding an earlier, 1934, version to be unconstitutional as an invasion of State sovereignty even though the state legislature had expressly authorized its political subdivisions to invoke the federal

procedure. Presumably, it continues in S. 2597 out of deference to *United States* v. *Bekins*, 304 U.S. 27 (1938), which relied in part on § 83(i) to conclude that, since the bankruptcy court was given no control over the property or revenue of political subdivisions of the states, there was no infringement of State sovereignty. In my judgment, this constitutes too much deference to out-moded constitutional interpretation. Since the *Ashton* case was decided this mechanistic concept of state sovereignty has been abandoned by the Supreme Court in favor of a more flexible concept which permits cooperative action by state and federal governments to serve legitimate public purposes. *Steward Machine Co.* v. *Davis*, 301 U.S. 548 (1937); *Helvering* v. *Davis*, 301 U.S. 619 (1937). See also *Maryland* v. *Wirtz*, 392 U.S. 183 (1968). And the opinion in *Bekins* was concerned more with distinguishing the *Ashton* decision than with providing a definition of federal government power. It is enough that S. 2597 requires in § 816(d), as does § 83(e) of present Chapter IX, that "the petitioner is authorized by law to take all action necessary . . . to carry out the plan." To preserve also in § 801(b) of the bill the additional restriction of § 83(i) of Chapter IX is to forbid a restructuring of the City's fiscal system which may be essential to any successful plan of debt adjustment. Thus S. 2597 would perpetuate one of the substantial inadequacies of present Chapter IX which is not confined to large cities.

Section 801(b) of the Administration's bill also preserves the proviso of § 83(i) of present Chapter IX suspending the operations of any state law "prescribing a method of composition of indebtedness" which would be binding on dissenting creditors. If the "composition" referred to were defined in its usual sense as a plan which would scale down the amount of debt which the city must pay in order to obtain a full discharge of those debts, the proviso would not apply to an "extension" plan under which maturities are extended but the amount of debt payable is not scaled down. But as "composition" is defined in § 802(3) of the bill and § 83(a) of present Chapter IX, it would include what is also an "extension" plan. This was doubtless intended when the proviso to present § 83(i) was added in 1946 in reaction to the decision in *Faitoute Co.* v. *City of Ashbury Park*, 316 U.S. 502 (1942), that the prohibition against state laws impairing the obligation of contracts in Art. 1, § 10, Clause 1 of the Constitution is not violated by a state debt adjustment law under which a city both reduced the interest on and extended the maturity of debt outstanding when the state law was passed. The continuation of this proviso would be questionable even if adequate provision for municipal debt adjustment were contained in the Bankruptcy Act. But it is remarkable in any event to see the continuation of the proviso sponsored by an Administration whose posture in all other respects is that the City and the State should work out their own problems without federal assistance.

While I am on the subject of definitions, let me point out that the definition of "composition" in § 802(3) of the bill is unnecessary, since the broader definition of the plan contained § 813 of the bill—and borrowed from § 83(a) of Chapter IX—covers the same ground and more. It is, moreover, confusing, since S. 2597 follows the inexplicable pattern of Chapter IX in first defining "composition" without defining "extension" and then referring thereafter in § 804(b), § 813, and § 814(a) to a "plan of composition or extension" while referring in § 806(b) to a "plan of composition."

Still on the subject of definitions, in the interest of clarity, the definition of claims in § 802(2) of the bill should be broadened to mean what was clearly intended: "the term 'claim' [means] *includes* a demand for performance of an obligation to pay money, whether matured or unmatured, *secured or unsecured, absolute or contingent, liquidated or unliquidated*."

One more definition causes me great trouble. Section 802(5) of the bill provides that where securities are outstanding under a trust indenture, "the term 'creditor' means only the trustee" under the indenture. If this is intended to mean that only the indenture trustee receives the notices provided for by §807(a) of the bill it is at least unwise and possibly a denial of procedural due process of law to the securities holders. It is also contrary to the better practice embodied in present Bankruptcy Rule 10–209 under which notices are sent to both the indenture trustee and to the security holders. If, in addition, this definition is intended to mean that only the indenture trustees can vote on the plan under §814(a), it is indefensible on any ground. The security holders are disfranchised in favor of an indenture trustee who may, by reason of its own investments, have a conflict of interest with the security holders and who otherwise is likely to be wholly incompetent, because of ignorance, to cast their votes for them. It is in recognition of these facts that § 198 of the present Bankruptcy Act forbids in-

denture trustees to vote on a plan in the Chapter X reorganizations of private corporations.

My next concern is with the requirement in §803(a) of the bill that, before the city can seek relief under the proposed new Chapter XVI, it must be "specificially authorized by the State to file a petition." As I previously indicated, it is enough that §816(d) requires that the city be authorized by law to take all action necessary to carry out the plan. To require the cities in addition to obtain specific state approval for the filing of each petition is to ignore the fact that time is frequently of the essence in the filing of petitions for bankruptcy relief and to subject a beleagured city to unnecessary delays and political vicissitudes. In this respect S. 2597 contains an inadequacy—for large and small governmental units alike—not contained in present Chapter IX.

Even more serious is the provision in §804(a) of the bill that a petition is "insufficient to invoke the jurisdiction of the court" unless accompanied by a plan which petitioner "certifies" is fair, equitable, and feasible and unless also accompanied by a statement of petitioner's current and projected revenues and expenditures adequate to establish that petitioner's budget "will be in balance within a reasonable time after the adoption of the plan." This provision is supposed to be an improvement over the requirement of present § 83(a) which requires that the plan be filed with the petition and be accepted in advance by creditors holding 51% of petitioner's debt—a requirement which many cities with more or less than 1,000,000 population cannot meet for the simple reason that they cannot identify and locate 51% of their creditors. But the proposed cure seems little better than the present disease.

In the first place, all experience with private debtors under present Chapter X, which seems highly relevant here, demonstrates that no viable plan can be formulated until well after the time of filing the petition. Only after the debtor has committed itself to a bankruptcy adjustment and creditor actions have been stayed is it possible for the debtor to bargain meaningfully with its creditors about the content of a feasible plan. Hence the requirement that the plan be filed with the petition can lead only to the filing of boilerplate plans which, as all informed parties well known, cannot be confirmed without later extensive modification as authorized by § 815 of the bill.

Secondly, the debtor's "certification" that such a meaningless plan is fair, equitable, and feasible, can be contested by any creditor pursuant to § 806 at any time up to ten days before the hearing on modification. Such a contest will precipitate a lengthy hearing during which extensive evidence of the debtor's financial condition and particularly of its probable future earning will have to be taken before the court can determine whether the meaningless plan is fair, equitable, and feasible.

The creditor's objection under § 806, moreover, may challenge the petition's statement of revenues and expenditures designed to show that its budget will be balanced within a reasonable time after adoption of a plan. This, again, will lead to protracted hearings and lengthy disputes over what is a "balanced budget" the propriety of the city's accounting procedures. Since the bill proffers no uniform set of accounting principles for the cities eligible to file a petition under proposed Chapter XVI, the court will be left at large in each case to pick and choose among accounting methods which are acceptable and those which are too "creative"—just as it will be left at large to determine what is a "reasonable" time (after its estimate of the time necessary to obtain an adopted plan) within which the budget must be balanced. (Quite apart from the litigation-inspiring qualities of these required allegations, the "balanced budget" requirement seems as a substantive matter: (1) To forbid cities that want to and can invoke the proposed Chapter XVI to to engage in the deficit financing which the United States, many other governments and many private enterprises pursue too enthusiastically; Keynesian economic principles are to be repealed for such cities. (2) To deny relief to the cities most in need of it.)

Months and even years could be consumed, then, before the court issued its ruling on a contest to a meaningless petition. Additional months or even years could be consumed on appeal. And since such a contest can be initiated under § 806 at any time up to ten days before the hearing on confirmation, it could well be that several years would be consumed before it was even determined whether the case was properly in court.

If, moreover, the ultimate ruling was that the petition was insufficient, the language of § 804(b) ("a petition shall be insufficient to invoke the jurisdiction of the court unless it contains the proper allegations) suggests that such a

ruling would constitute a ruling that the court lacked jurisdiction from the outset. Where does this leave the certificates of indebtedness authorized by the court pursuant to § 811 of the bill? The most likely answer seems to me to be that it leaves them void and unenforceable, but whatever the ultimate answer may be the mere presence of this obvious question is not likely to enhance the marketability of the certificates.

Passing to another matter, I take it that it should not be necessary to do more than point out to the Committee that under the venue provisions of § 804(c), which preserve another inadequacy of § 83(a) of present Chapter IX, if the City of New York were to elect to file a petition under the proposed new Chapter XVI the petition would have to be filed in Brooklyn. I believe I am correct in my understanding that the "major part" of the City is in the Eastern District of New York and not in the Southern District where its principal offices are located.

The automatic stay of creditor actions, including set-offs, imposed with the filing of a petition by § 805(a) of the bill is—to the extent that it reaches set-offs—improvement over present Bankruptcy Rules 10–601 and 11–44. But the Committee may wish to consider some revision, along the lines of the National Bankruptcy Conference's recommended revision of § 7–204 of S. 236, to extend the stay to prepetition setoffs and to authorize the court to order a person such as a bank to continue to honor the debtor's checks, as was done by the court without express aid of statute in the Penn Central reorganization case. *In re Penn Central Transportation Co.*, 453 F2d 520 (3rd Cir. 1972), cert. denied 408 U.S. 923 (1972).

Moreover, I have two difficulties with § 805(e) of the bill. (1) It, like § 801 (b), seems to me to defer too much to outmoded notions of state sovereignty. (2) As a matter of drafting, it is unclear whether its limitations are intended to apply to the automatic stay provided for by § 805(a) on whether it applies only to stays issued by the court pursuant to § 805(d).

I have previously referred to the provision in § 806(a) allowing any creditor to contest the petition at any time up to ten days before the hearing on confirmation of the plan and to the confusion that would ensue if a successful contest were made late in the proceeding after certificates of indebtedness had been issued pursuant to § 811. There is no need for preserving such a protracted opportunity to challenge the petition. Under the comparable situation covered by Bankruptcy Rule 10–112, creditors may have no more than 30 days after the filing of a voluntary Chapter X petition to challenge that petition.

Section 807 provides that all notices in the case shall be given by the court clerk. In view of the large numbers of creditors entitled to notice, this imposes a burden on the clerk's office which it will not be well equipped to handle. I suggest that notices should be given by "the petitioner or another person designated by the court." Since § 807(e) contemplates that the cost of notice will normally be borne by the petitioner in any event, which seems appropriate, it also seems appropriate to charge the petitioner with the mechanics of the job unless, in a particular case, circumstances indicate that another person should be designated by the court.

Section 808, authorizing any creditor "for all purposes of this chapter to act not only in person or by an attorney, but also by "a duly authorized agent or committee" is too broad since, if read literally, it would authorize laymen to practice law. This provision should be conformed to Bankruptcy Rule 910(a), which authorizes a creditor to "perform any act not constituting the practice of law by an authorized agent" but otherwise confines the creditor to acting in the case in his own behalf or through an attorney at law.

Section 809(a) requires the list of creditors, so far as petitioner can identify them, to be filed with the petition. This is a very burdensome requirement which may substantially delay the filing of a petition in a situation of urgency and which serves no real purpose since § 807(a) does not contemplate immediate notice to creditors of the commencement of the proceeding. This provision should be conformed to Bankruptcy Rule 10–108 which authorizes the court to fix the time for filing the list of creditors after it has had an opportunity to appraise the magnitude of the task and to determine when the list will be needed.

The provision in § 810 that, in the absence of objection, a claim is established by the list of claims unless it is disputed should be amended to exclude also claims which are contingent and unliquidated. See Bankruptcy Rule 10–401(a). And, as I suggested earlier in connection with § 807, the petitioner or another

person designated by the court should send out the notices required by the last sentence of § 810.

The provision in § 811 authorizing the issuance of certificates of indebtedness in order to provide essential funds while the case is pending is a very desirable improvement over present Chapter IX, but the priority which may be given to such certificates should be clarified. If the certificates are only given priority over prepetition unsecured obligations they merely rank, as first priority administration expenses under § 812, with all other authorized credit extensions obtained by the petitioner while the case is pending and the only value of the certificate to its holder is to establish that the city was authorized to obtain the credit extension covered by the certificate. As experience under Chapter X has shown, it may in many cases be essential, in order to market the certificates, to give them a higher priority, ahead of prepetition secured claims. Section 811, by authorizing priority over "existing obligations," as does § 344 of Chapter XI, would incorporate the existing uncertainty as to whether certificates of indebtedness issued in a Chapter XI case can be given priority over prepetition secured claims. The provision should be amended to conform to § 116(2) of Chapter X, which makes clear that this can be done in a Chapter X case. The Committee might also want to consider giving the court authority to give certificates an intermediate priority—ahead of other administration expenses but below prepetition secured claims.

I would also suggest that the provision in the last sentence of § 811 giving the court "plenary jurisdiction" over any action to enforce the certificates is meaningless when addressed to the federal district courts to which the administration of the proposed new Chapter XVI is apparently to be entrusted (see § 820). The distinction between "summary" and "plenary" jurisdiction is meaningful only in discussing the jurisdiction of referees in bankruptcy. Apparently what was intended by the last sentence of § 811 was that the federal district court should have "exclusive jurisdiction" over actions to enforce certificates of indebtedness.

I strongly urge the elimination of § 812(3), which would preserve a priority, ahead of all other prepetition claims, for federal claims entitled to priority under Rev. Stat. § 3466, 31 U.S.C. 191. There will be no federal tax claims against the state governmental units covered by this bill, and with respect to other federal claims against the cities there is no apparent reason why the United States should not make at least the same sacrifice as other creditors in the rehabilitation of the city. The federal priority for nontax claims would be eliminated by the provisions of § 4–405(a) of S. 235 and S. 236.

Section 813 of the bill authorizes rejection of executory contracts and unexpired leases by provision in the plan, but the bill is otherwise silent about rejection of such contracts and leases. This seems to me insufficient since it deprives the petitioner of any power to reject a contract or lease prior to the confirmation of a plan. Thereby the debtor is deprived of bargaining power to negotiate with the other party for a modification of the terms of executory contracts and leases while the case is pending and of any opportunity to get rid of undesirable contracts or leases early in the proceeding. Power to reject prior to confirmation, with approval of the court, is now contained in § 116(1) of Chapter X, § 313(1) of Chapter XI, and in § 4–602(a) of S. 235 and 236. It is then provided in § 202 of Chapter X, in § 353 of Chapter XI, and in § 4–602(c) of S. 235 and 236 that any person injured by the rejection shall have an allowable claim for damages with a limitation on the amount of a landlord's claim. In § 4–403(b)(5) of S. 235 and § 4–403(b)(6) of S. 236 that limit is fixed at the rent reserved by the lease for the year following the date of the petition.

At a time when Chapter XI requires acceptance of a plan only by a majority in number and amount of each class of creditors (Bankruptcy Act § 362(e)), when pending bills before Congress would reduce the Chapter X requirement (§ 179; Bankruptcy Rule 10–305(e)) of two-thirds in amount of those voting in each class to majority in amount of those voting in each class (§ 7–308(d) of S. 235 and S. 236) and would have the same requirement for debt adjustment plans for governmental units (§ 9–307(c)) of S. 235 and § 8–307(c) of S. 236), the Committee may wish to change § 814(a) of S. 2597, which requires acceptance of a plan by two-thirds in amount of any class of creditors. The necessary effect of this requirement is to give a veto power to the holders of one-third in amount of any class of creditors, a power which might be vested in one or a few large institutional investors.

Section 814(a) also contains in its proviso a "cram down" provision for dissenting classes of creditors which is modeled on § 216(7) of Chapter X and the

proviso in the third paragraph of §77(e) for railroad reorganizations which was applied and held constitutional in *RFC* v. *Denver & Rio Grande Western Railroad Corp.*, 328 U.S. 495 (1946). This provision, it seems to me, is an improvement over the "cram down" provision in the proviso in § 83d of present Chapter IX.

But § 814(c) of the bill preserves the proviso in § 83(b) of present Chapter IX under which creditors are to be classified in separate classes solely on the basis of (1) specific property or revenues pledged, (2) any other preference provided by other law, and (3) the absence of any pledge or preference. This provision is much too rigid and deprives the petitioner of the opportunity, available under Chapter X and XI, to pay off small claims, regardless of security or priority, in order to expedite the proceeding. The provisions of § 197 of Chapter X and § 351 of Chapter XI, giving the court some flexibility and in the classification of creditors, are preferable and the provisions of § 7–302 of S. 236 are even better.

I believe another subsection should be added to § 814 of the bill, incorporating the provisions of present § 83j of Chapter IX, providing that if some creditors have taken new evidences of indebtedness under the plan as part of an informal arrangement before or after the filing of the petition, they shall not be limited to the amount of their claims under the new securities, but shall be treated as creditors assenting to the plan in computing the percentage of acceptance required for confirmation of the plan by the court. This provision was added to Chapter IX in 1938 to overcome the decision in *In re City of West Palm Beach*, 26 F.2d 85 (5th Cir. 1938), that creditors who had accepted new bonds under the plan which scaled down their original claims before the Chapter IX petition was filed could not be counted among those who had accepted the plan for purposes of confirmation.

My objections to the budget-balancing requirement of § 804(b) of the bill are equally applicable to the budget-balancing requirement of § 816(d)(7) as a condition to confirmation of a plan. A finding that the plan is feasible as a condition to confirmation has been added to § 816(d)(1)—a desirable improvement over present § 83(e)—and that is enough. Feasibility, and not budget-balancing, is all that is required by § 221(2) of Chapter X for corporate reorganizations. If the latter requirement had been present in Chapter X, many successful reorganizations would never have occurred.

The penultimate sentence of § 816(d) appears to require the court to dismiss the case if it cannot confirm the first plan considered by it for confirmation. This provision is much too rigid, particularly in view of the proviso in § 801(b) forbidding the state to provide a procedure for working out a plan that will bind dissenting creditors. Where does this leave the city and its creditors? The city is not like a private button factory which can be liquidated if it cannot come up with a plan which can be confirmed—as is recognized by § 4 of the present Act and by §§ 4–201 and 4–204 of S. 235 and S. 236 excluding cities from straight bankruptcy liquidation. If the court cannot confirm the first plan for municipal debt readjustment which is submitted to it, the bill should make it clear that the court is not obliged to dismiss the proceeding but should have discretion to send the matter back for the parties to try again.

The last sentence of § 816(d) should be deleted as unnecessary. It is copied from the last sentence of the third paragraph of present § 83(e), which was added in 1946 in response to the decision in *Kelley* v. *Everglades Drainage District*, 319 U.S. 415 (1943). But a careful reading of that decision reveals that it and the added sentence say the same thing.

Consistently with my suggestion for amendment of the definition of "claim" in § 802(2), § 818(b) should be amended by adding at the end of the first sentence the words "unliquidated or contingent."

Section 819, authorizing the court in its discretion to retain jurisdiction of the case for as long as it determines is necessary to assure execution of the plan, is an improvement over present Chapter IX but would be further improved, in my judgment, if it reads: "The court *shall* [may] retain jurisdiction of a *case* [proceeding] under this chapter *until the discharge of all claims against the petitioner provided for by*] [for such period as it determines is necessary to assure execution of] the plan."

This would not mean that the court would remain perpetually preoccupied with the case after the distribution contemplated by § 818, but that it would retain jurisdiction until payment or refinancing of the securities issued under the plan, in the event of a substantial change in the city's financial condition—

for better or worse—to deal with the situation. To deal with such a situation, the court should also be given power to entertain proposals to modify the plan after confirmation.

Mr. COUNTRYMAN. I try to confine myself now to a few highlights of the bill now before you, S. 2597.

First, section 813 of that bill provides that a plan may include provisions for rejection of executory contracts and leases, but that is the only mention of executory contracts and leases in the bill. And this seems to me to be insufficient.

Section 804(b) requires a proposed plan to accompany the petition. I share Mr. Patchan's misgivings about that, particularly since S. 2597 does not contain what present chapter IX contains, provisions for a 120 day stay before the petition has to be filed. I am afraid that what this will lead to is boiler plate plans which will then have to be modified under the authority given in the bill for subsequent modifications before confirmation.

I would point out that if a private organization is seeking rehabilitation under either present chapter X or present chapter XI, our new bankruptcy rules, rules 10–301 and 11–36, provide that the court shall fix the time for the filing of the plan sometime after the petition is filed, and so do the pending bills before you, for complete revision of the Bankruptcy Act, S. 235 and S. 236.

But more importantly, this scheme deprives the debtor of any power to reject a contract or lease prior to the confirmation of a plan and thereby deprives the debtor of any bargaining position in an attempt to renegotiate a contract or lease with the other party, prior to confirmation, and of any opportunity to get rid of an undesirable contract or lease early in the proceeding.

Power to reject, with the approval of the court, prior to confirmation, is now contained in present chapters X and XI and in Senate bills 235 and 236. It should be included also in this bill.

Second, section 802, in paragraph four, provides that with respect to securities outstanding under a trust indenture, only the indenture trustee is to be treated as a creditor. I assume that means he is to be treated as a creditor in the amount of the entire outstanding issue under his indenture, although section 802 is not clear on that.

But assuming it means that, so that the votes of all of the security holders are not pared way down, if it means that and if it means that only the indenture trustee, and not the individual creditors, shall receive the notices provided for by section 807 of the bill, it is bad enough and contrary to present rule 10–209, governing chapter X cases and Senate bills 235 and 236, under all of which notice is given to both the indenture trustee and the security holders.

If it also means that only the indenture trustee may vote on the plan, under section 814, it is even worse, since the creditors, the real creditors, the holders of the securities are disfranchised in favor of someone who has no competence to vote on the plan. Voting by the indenture trustee in chapter X cases is now expressly forbidden by section 198 of the present Bankruptcy Act and should also be forbidden in this bill.

Third, I have difficulties with other definitions in section 802. The definition of claims in that section, it seems to me, is much too narrow. It should be made clear, which I am quite certain was intended, that it

includes secured as well as unsecured claims and that it includes unliquidated and contingent claims, matters which are made clear in the present Bankruptcy Act.

And the definition should not be cast in so that the term claim "means" but the term claim "includes" all of these types of creditors that I have indicated. That is the style used in the present Bankruptcy Act and in at least one instance, in the Supreme Court, it proved to be very important and salutory—that it said "includes" rather than "means."

Then I have difficulty with another definition in section 802, which defines the term composition in a way completely foreign to all bankruptcy lawyers I think. But thereafter, and throughout this bill, the bill speaks of a plan of a city which may either be a composition involving a reduction in the amount of claims, or an extension which involves no reduction, but a mere extending of maturities.

But the term extension—I am giving you the preconceived notion of what it is under the persent act—the term extension is nowhere defined in this bill. I think the definition of composition without a definition of extension is confusing, but I do not believe that either of those terms need be defined. The bill should simply refer throughout to a plan because section 813 adequately defines a plan to include composition or extension or both.

Fourth, some of the most amazing features of this bill are its provisions in section 804(b) that the petition must contain information adequate to establish that the budget of the petitioner will be balanced within a reasonable time after adoption of the plan; and the provision in section 816(d), that the judge must be satisfied that this is so before he can confirm a plan. And this is a requirement imposed on cities which are eligible to come under this chapter.

And another requirement of such cities is that they must be insolvent or unable to meet their debts as they mature at the time they filed the petition.

I do not know how much leeway is embodied in this concept of a reasonable time. And I do not know what varieties of accounting standards are to be permissible in forecasting the balancing of the budget, within this reasonable time.

I am rather inclined to agree with Mr. Scalia that there is no uniform system, of that I am sure, and that at least with respect to some municipalities, including perhaps some which might be covered by this bill, and by my count, there are only six cities in the United States which have more than 1 million inhabitants.

But it may be true in some of those cities that the kind of accounting which is employed is what some accountants describe as "creative" accounting. And I anticipate great quantities of litigation and great prosperity for lawyers practicing in this field as they litigate, one, over what is the proper system of accounting by which this determination is to be made, and two, whether the city's system corresponds to that proper system of accounting.

Moreover, section 804(b) requires not only that you set forth the provision that the budget be balanced, but also requires that the petitioner "certify" in the petition that the plan accompanying the petition is fair and equitable and feasible.

I have never seen such a requirement for a petition initiating a proceeding under this or any other bankruptcy act. Whether or not

the plan which is submitted is fair and equitable and feasible is the ultimate conclusion which the court is going to have to reach in this case, before it confirms a plan, after hearings on confirmation which will bring out all of the facts, because before the court can determine that the plan is fair and equitable and that it is feasible, it has to have a forecast of the future revenues of the city, out of which the new securities are to be paid. And it has to make evaluations of all of the existing claims affected by the plan so that it can determine whether these new securities are to be fairly allocated under the plan.

If the debtor is required to certify these conclusions, at the very outset of the proceeding, before any of the facts are established, and then under section 806, any creditor may contest the petition, which will trigger a hearing on these issues at the very outset of the proceeding, the ruling of the court, either that the petition was good or was bad, could be appealed and years could be consumed on this preliminary testing of the debtor's petition before we could ever get on with the business of trying to formulate a meaningful plan.

I have still another difficulty with this provision. Section 804(b) says that the petition is insufficient to invoke the jurisdiction of the court unless it contains adequate facts to establish that the budget will be balanced and a certification of fairness and feasibility of the plan. If a creditor contests this petition, which under section 806, he may do at any time up to 10 days before the hearing on confirmation, and if the court rules in his favor that the petition is insufficient under the language of this bill, as both the chairman and Senator Hruska have pointed out, the court is ruling that it never had jurisdiction of this case from the outset.

And then I believe, with respect to certificates of indebtedness which may have been issued long before we get this ruling, we are, Senator Hruska, in the position of the municipal bonds which were eventually held to be unauthorized and that the certificates of indebtedness are void.

Now Mr. Scalia tells us that section 811 takes care of all of this by saying that the Federal court has plenary jurisdiction over all questions of enforceability of the certificates. I believe he means exclusive jurisdiction because there is no concept of plenary as distinguished from summary jurisdiction in Federal district courts, although there is in bankruptcy courts. But let us assume he means exclusive.

In order to have exclusive jurisdiction, the court has to have jurisdiction first, it seems to me. And this court has just, in my hypothesis, ruled that it had no jurisdiction at all. So it seems to me to follow that any certificates of indebtedness theretofore authorized by this court are in fact unauthorized because of the court's lack of jurisdiction.

Finally, if the court is unable to confirm the plan finally submitted for confirmation because it does meet the various requirements as to fairness, feasibility and so on, section 816(d) requires it to dismiss the proceeding. Where does this leave the city?

The proviso to section 801(b) also forbids the State from making available to the city a procedure for working out a plan which will bind any dissenting creditors, but the city is not like a private corporation, a button factory, let us say, which can be liquidated under the Bankruptcy Act, if it cannot be financially rehabilitated. That much is recognized by the present Bankruptcy Act and by both Sen-

ate bills 235 and 236, which exclude cities entirely from the liquidation provisions of those acts.

We have heard much here today about essential services to be provided by a city, although I am not very clear about what is included within that concept. The President referred to firemen, policemen and nurses in emergency wards. I do not know where that leaves garbage collectors. I do not know where that leaves teachers. I do not know where that leaves mass transportation systems. But everyone seems to agree that some services provided by our cities are essential.

I presume that means that probably all cities and certainly the six cities covered by this bill are themselves essential, unless and until we can find someone else to perform those services. And I think there is something seriously wrong with a bill which would deprive those cities of all effective relief for their financial problems, which seems to me where this bill brings us when it says, "Well, Federal judge, if you cannot confirm this plan, dismiss the proceedings," which leaves the city in limbo.

Mr. Chairman, if I could take not more than two more minutes, I would like to address myself to some questions that were earlier raised: one about the cram down provision in this bill and its ancestry. I believe Mr. Patchan said he felt this was a good cram down provision. I believe it is.

The cram down provision originated in section 77, dealing with railroad reorganizations, and the Supreme Court has specifically held it constitutional as applied under section 77 in the reorganization of the Rio Grande Railroad. From section 77 it next turned up in chapter IX and later it came into chapter X. Chapter X was enacted in 1938.

I believe that by borrowing from the language of section 77 and chapter X, instead of from chapter IX, this bill has a better cram down provision than does present chapter IX and that the Supreme Court's decision as to its constitutionality in the railroad context would probably be carried here also.

Second, I would have to disagree with Mr. Scalia about where New York would have to file its case. I think clearly it would have to file it in the eastern district of New York because that is where the major portion of the city is. I assume major portion is speaking of area and not population, and if that is correct, the clerk's office for the eastern district is in Brooklyn. There is no way, under that provision as I read it, that the petition could be filed in Manhattan or anyplace else in the southern district of New York.

Finally, in the discussion of debt certificates or certificates of indebtedness, as I am used to calling them because of prior usage, a certificate of indebtedness that is not given priority over a secured claim is no better off than other first priority administration expense, save for this: If the court authorizes a certificate, it has said, in effect, to the debtor, well this is an authorized administration expense so that that cannot be fought about later when the certificate holder comes in later to get his first priority. Any other administration expense may lose out if somebody convinces the court that the debtor was not authorized to incur it. But that is the only advantage of a certificate of indebtedness which is not given priority over secured claims. It shares pro rata with all other administration expenses. And if there are not enough assets to pay all of the administration expenses, is not going to be fully re-

paid. It is going to get the same percentage as all other administrative expenses.

So in order to get a better position on that, the certificate of indebtedness must be given the judge who authorizes it a priority over lien claims. And I wish that Section 811—I believe it is section 811 of this bill—were clearer than it is that the priority may in a proper case, be given over secured claims.

Present chapter X is very clear on that; it authorizes these certificates and says they may be given priority over secured or unsecured claims. The present chapter XI reads much as this bill. It simply says they may be given priority and there is great uncertainty right now, not resolved in the cases, as to whether in a chapter XI case, you can give the certificates priority over secured claims. Some bankruptcy judges have done so, but whether they acted properly has not been tested. I would think it is very desirable to make clear in this bill that the priority which may be given these certificates may be over lien claims because that is the only meaningful priority. Of course they have priority over any prepetitioned, unsecured claims. They would have it even if they were not embodied in certificates because they are part of the expenses of administration, which this bill, like all other provisions of the Bankruptcy Act, gives a first priority over any other unsecured claims.

Thank you.

Senator BURDICK. Thank you gentlemen. I have some questions for both of you gentlemen.

What mechanisms, Mr. Patchan, do you provide between States that would comply with your plan as you suggest?

Mr. PATCHAN. I would empower the court to appoint a committee, a committee of officials perhaps, from the petitioner's area, be it his community, his region or the State. They would be brought into the mix of plan formulations to devise a plan and hopefully produce statehouse support for it if that is needed. And I would give the committee standing in the court as interveners, to give them authority to submit their own plan if necessary. I think in that way, you can bring in the larger area where it may be necessary to transfer perhaps hospitals or the airport or transit systems, the functions which cannot be cut off and cannot be unilaterally transferred. They must be accepted by these larger authorities.

Senator BURDICK. You have had requirements in the past that plans in chapter cases were to be filed with the petition. Why do you say that requirement is no good here?

Mr. PATCHAN. Well, they were permissible in some instances in the past, but the requirements for plans to be filed with petitions were eliminated. They were eliminated because it was not workable. It semeed impractical to expect a meaningful plan at the outset of the case. Practitioners, frankly, will file a plan just to comply with that requirement, with no intention perhaps that it be the plan ultimately considered by the creditors and by the court. I think a similar action would be taken here where you force a party to file a plan at the very outset of the case.

In addition, it would seem in any instance when a case is filed, the initial period of time is most disturbing to the city affairs. The early days of a case may be the worst time to formulate a plan, especially if it calls for incorporation of outside responsibilities.

Senator BURDICK. If you would not require a plan to be filed with the petition, would you require it to be filed within a certain period of time after the filing of the petition?

Mr. PATCHAN. Either that, sir, or as maybe permitted by the court after hearing and due consideration. I would give the court discretionary power to set the time for the filing of the plan.

Senator BURDICK. You said that the notice provisions in the bill are good. Would you have the district court clerk give the notices?

Mr. PATCHAN. That is the one portion where I would recommend a change. That would be the only area of change. I would have the debtor himself give the notice. It would burden any court to give what may be thousands of notices and work on innumerable notification processes. And I think we could transfer the work to the debtor. The debtor itself could handle that process and then report to the court in regard to the notices.

Senator BURDICK. Section 814(c) provides the classification of claims on the basis of source. Do you believe that to be a proper method of classification?

Mr. PATCHAN. I do not believe it is fully flexible enough, sir. That provision is in the present law. There may be circumstances when subclassifications of creditors is helpful. A plan may call for full payment of all creditors of $100 or less perhaps. They may not be treated in that manner under this bill.

If you have to consider the source the sole basis for classification, you cannot stratify that classification sufficiently. I do not think it is flexible enough although generally, it is proper.

Senator BURDICK. I think both you and Mr. Countryman referred to the fact that one of the three conditions that are attached to the petition, is that you have to state that the plan is fair and equitable. I believe your testimony was that that was really a question of law and did not state any facts. Would you eliminate that entirely?

Mr. PATCHAN. I would not eliminate it for the court ultimately. I would eliminate it at the outset of the case certainly.

Senator BURDICK. Let us talk about these three conditions required under the bill at the time of filing the petition. How would it work if those conditions were met as a precondition for the acceptance for a workable plan. Would those three conditions, then, not have to be part of an acceptable plan?

Mr. PATCHAN. Senator, you mean a precondition for a confirmation of a plan?

Senator BURDICK. Yes.

Mr. PATCHAN. Yes. I would think at confirmation, it would be a proper test to apply to the plan. But by that time, you have determined an awful lot of things which go toward the conclusion you are seeking, whether it is indeed feasible and whether it is fair and equitable as a plan. Many things are behind you. You have worked out this plan. You may have worked out certain executory contract problems. You may have slimmed down and scaled down certain burdens of the city. And now you can see and measure whether that plan now before the court, already accepted by creditors, is indeed fair, equitable and feasible. It is really the end of the line for the case as far as the plan is concerned. But it certainly has no place at the outset. And as the professor has suggested it will, in addition require a determination of a proper

accounting system to determine whether the budget is truly in balance. I gather that cities with problem today continue to show their budget in balance.

In addition to finding standards of accounting as an area of employment for lawyers, the requirement would raise the opportunities for litigation at the outset of a case. I think it is almost impossible to handle the matter properly at the begining of a case. The only result would be a delay of the administration and the proceeding.

Senator Burdick. Were you in the hearing room this morning when I asked a hypothetical question of what would happen to a debt certificate if a challenge to the petition was held to be void? Would there be jurisdiction or would there not be jurisdiction under those situations?

Mr. Patchan. Yes; I was in the room. The way I read this bill, the Court would not have jurisdiction. Therefore, everything it did—it would turn the calendar back to day one—everything it did was improper. Certainly if we are thinking about New York—and this apparently is what this bill was written for—well, this particular question is up in the air, and would be at least for the foreseeable future. We are damaging the marketability of those certificates right now by just raising this question. And it is a question that is properly raised.

My belief is tht the court would be improperly issuing certificates if it did so before it had jurisdiction.

Senator Burdick. Mr. Countryman, I have a few question for you and then we will turn both of you gentlemen over to Senator Hruska.

If an executory contract or a lease is rejected, would the other party have a provable claim?

Mr. Countryman. I believe that is very doubtful under this bill, Mr. Chairman. Chapters X and XI expressly provide that when an executory contract or lease is rejected, the other party to the instrument has a provable claim for any damage he suffers as a consequence. Since there is no such provision in here, I would be very concerned that the courts would say, well, the omission must have been intentional; it must mean something and what it must mean is that he has no provable claim for his damages and therefore cannot participate in any distribution under the plan. I would not believe that that ought to be clarified. I do not believe that result was intended by the draftsmen of this bill.

Senator Burdick. You have heard the questions asked this morning about the pension plans. How would they be taken care of under the proposed bill?

Mr. Countryman. They fall into three classes. This gets back to a point Senator Hruska raised too. It is not my understanding that those pensions are fully funded. My understanding is that they are about 17 percent funded. To the extent that they are funded, I agree with Mr. Scalia that those moneys are not property of the debtor any longer; they are the property of the retired employees. And they cannot be taken away from them. But I believe that is only to the extent of about 17 percent.

Now let us look at the unfunded part. Here the petitioners, the employees, fell into two categories. Those who have already retired no longer present an executory contract because they fully performed their side of it, and an executory contract, as that term has been inter-

preted by the courts in its present use under the Bankruptcy Act, means a contract where some part of the performance of both sides is still executory. What that means is that without any decision of the debtor to assume or reject the contract, those employees who are now retired have a claim for the balance of their pensions which will have to be dealt with by the plan.

With respect to those employees who have not yet retired—and I am now talking about the nonfunded part of the pension contract—who have not retired, their's is an executory contract, and the debtor would have a choice at least in the plan, and I suggest even before the plan is confirmed, whether to assume the contract, in which case the debtor would remain bound by the terms of the contract to make those contributions, or to reject it. And as I have just suggested in response to a previous question, it should at least be made clear that if it is rejected, then they have a provable claim for their damages which should be recognized.

Senator BURDICK. Is there any provision in the present Bankruptcy Act or in the two bills we are now considering in the committee, S. 235 and S. 236, requiring the debtor, public or private, to establish that his budget was balanced before he can obtain relief?

Mr. COUNTRYMAN. No sir, there is not.

Senator BURDICK. If a creditor contested a debtor's petition on the grounds that the proposed plan is not fair and equitable, would the ruling be res judicata be in the later hearings on confirmation?

Mr. COUNTRYMAN. Well, I think it would be res judicata as to what the court decided when it decided the petition was proper, but what did it decide?

It decided that the proposed plan, as of the time that the court decided it on the facts available to the court, would be fair and equitable and feasible. It decided, at the time it decided that question, that it looked like the budget could be balanced within a reasonable time in the future and that the plan was fair, equitable and feasible, and since all creditors are supposed to be given notice and made parties to this hearing, on that question, I suppose it would be res judicata as of that time. But that does not really mean that it would even save us much time in the long run because two things can happen before we get down the road to where the court is going to confirm a plan and has to ask itself the same questions again.

One, there may be a considerable change in the financial condition of the city between the time of that earlier determination and the time of confirming the plan. So that what looked like a fair, equitable and feasible plan back at the time of the earlier ruling may no longer appear to be fair, equitable, and feasible. Where it appeared at the time of the early ruling that the budget would be balanced in a reasonable time, things may have deteriorated to the point where the court can no longer say that. So it would still have to make a second ruling based on the change in circumstances.

Moreover, this bill provides that a plan may be modified at any time prior to confirmation. Certainly if that is done, there would have to be a new ruling on the question. Is this modified plan fair, equitable, and feasible?

Senator BURDICK. You seem to have objection to those conditions appearing in the petition on the grounds that it may be raising a juris-

dictional question, but do you have any objection to those conditions being placed in the bill requiring them as necessary ingredients of confirmation of any plan?

Mr. COUNTRYMAN. Not to the fair, equitable and feasible requirements. I applaud those requirements. And incidentally, Mr. Scalia did not note, this morning at any rate, that he improved on present chapter IX, which has no feasibility requirement in it. I think that is a serious defect of chapter IX. If read literally, the court can confirm any kind of a plan that seems to be fair in its allocation of new securities without any inquiry into whether it is feasible in the sense that we can expect the debtor to perform it. But I do not approve of that requirement of a balanced budget or of the court being satisfied that the budget would be balanced in a reasonable time before it confirmed a plan.

Now I am not enough of an economist to even venture to give this committee an opinion about whether we should now repeal Keynes' economics for cities and abolish all deficit financing, but it seems to me that with the requirement of feasibility in there, that is enough and that the court, in many instances, would be able to find that a plan was feasible even though it could not find that the city's budget would pretty soon be in balance. Indeed, I am certain from our experience under chapter X where we have a requirement that the plan be feasible before it is confirmed but no requirement of a balanced budget, that many plans are confirmed where it could not be forecast that the budget could be balanced within a reasonable time and that they were properly confirmed. And that is quite apart from all the difficulties I adverted to earlier about are we going to set up a uniform system of accounting for cities for purposes of this bill.

Senator BURDICK. Suppose the bill did contain these provisions we have discussed. Suppose the court could not find that it was fair and equitable, and that it was a balanced budget, what would the court do with the case?

Mr. COUNTRYMAN. I have suggested that the Court should not dismiss the case. I think the Court should send the parties back to the drawing boards. I believe that by this stage in the proceedings, if the Court will not confirm the first plan that is presented to it for confirmation, you are going to find the creditors more tractable in working out another plan because in very many instances a plan which gave them less, and which hence might be feasible where the earlier plan was not, would still look much better to them than the limbo into which both they and the city are going to be thrown if the case is dismissed. Because, as I indicated in my opening statement, there seems to be no other effective remedy at all, either for the city or for its creditors.

Senator BURDICK. Senator Hruska?

Senator HRUSKA. Thank you Mr. Chairman.

I want to say at the outset, as you were testifying, professor, my mind went back to the time when we reported three times a week to courses in law school and listened to profound words from teachers like yourself. That caused a little homesickness in the mind of at least one Senator up here.

As to the lecture from the judge, we ordinarily got that from the Bench, when we either were regarded with favor, or when we were regarded with disfavor.

We appreciate both of your appearances here. They are very, very helpful.

In that connection, if written statements will be submitted, may you be reminded that time, in this instance, is highly of the essence, because of the situation with which we are confronted. And anything you could submit at an early date would be highly appreciated.

I would not want to get into too extended a questioning here because I would want to analyze the transcript a little and without duplicating any questions get at a systematic questioning process.

However, one of the things that we have talked about, professor, was the subject of what is essential in a city's functioning. And I can think of a lot of things right off the bat.

Of course, the President's enumeration of firemen, policemen, and nurses was not intended to be exclusive, as all of us know.

Mr. COUNTRYMAN. Right.

Senator HRUSKA. But how about free tuition to universities? Is that an essential service? What about recreation? What about the provision of the free use of golf clubs or tennis rackets, or golf balls, or tennis balls, or things of that kind?

It opens a terrific question to define what is essential and what is not.

Now, then, in defining essential services and applying that definition, would there be a violation of section 805(c) which is found at page 6 in the bill that says "that no stay, order or decree of the court may interfere with any of the political or governmental power of the petitioner."

Or, does section 801(b) which says that "nothing in this chapter shall be construed to limit or impair the power of any State to control by legislation or otherwise any political agency or instrumentality to those two provisions on the necessity of separating essential activities from nonessential ones," offer difficulty?

Mr. COUNTRYMAN. Well they offer great difficulties for the courts that have to consider them. The first court that would have to consider the question is the court which is handling this case, the court in Brooklyn, as I suggested, and it would have to decide whether anything it had ordered interfered with an essential service.

If it decided that it did not, then that could be appealed to the court of appeals and it would have the question. And from there you could try to get to the Supreme Court, which might or might not take it, but the last court to rule on it, that would be the end of the question.

But there is another big piece of litigation. And I have great difficulty with the concept. I have worried about it, some of the same things you mentioned, Senator, and I do not know what the answer is for a free city university.

I am not even sure what the answer is for mass transportation. It occurs to me that in some cities, what would be essential, probably any city covered by this bill, would not be essential in other cities, if the bill were broadened to cover more cities.

For instance, as I heard someone else suggest, garbage service is certainly essential in New York City. But I live in a small city now where garbage service is not really essential. We could all make one trip a week to the city dump and dispose of our own garbage.

But many of these other things I simply cannot answer. Perhaps it ought to be narrowed in an effort to give it more precision.

I discussed this with Mr. Patchan and he came up with a phrase that carries more appeal to me than just the term essential, essential for health and welfare.

Now when you say that I suppose you would be closing the recreational facilities you referred to, unless some judge wants to decide that is essential for health. Maybe you have also dictated that the New York subway ought to be terminated in the interest of health and safety.

Senator HRUSKA. Judge Patchan, would you have anything to add to that and in your answer would you comment as to whether or not welfare payments might be considered an essential service.

Mr. PATCHAN. That is why I was interrupting, sir, because I wish to correct the impression the professor has of my statement. My comment to him was health and safety, not health and welfare.

Mr. COUNTRYMAN. I misspoke; I am sorry.

Mr. PATCHAN. I would defer to what is necessary for the public safety and the public health.

Now, within that definition, we have enough problems, obviously. But those are the two orbits to which I would direct the debtor certificates and the area of interest now encompassed in this proposal for essential services.

Mr. COUNTRYMAN. Might I add one more thing, Senator Hruska?

Senator HRUSKA. Certainly.

Mr. COUNTRYMAN. I think the contribution that this bill makes to the area, although I have criticized the exact drafting of it, is section 811 authorizing the use of certificates of indebtedness. There is nothing like that in the present chapter IX, although there is in chapter X and XI for private corporations. But as I understand this, this is the major contribution to maintaining these essential services, however they may be redefined and whatever the redefinition is for the provision that we have been referring to.

I have lost the section we were talking about now which says the court may not interfere with essential services. However that be redefined, I would suggest that it replace "upon good cause shown" in section 811 that it should be the same test for the issuance of certificates.

Senator HRUSKA. Thank you very much.

Could you comment briefly on that problem of setoff of banks? I know that is going to come up.

Mr. COUNTRYMAN. I do not like the fact that the present Bankruptcy Act, at least in straight bankruptcy proceedings, authorizes a setoff. It seems to me inconsistent with the general policy of equality of distribution and allows any creditor—and this principle operates for the benefit of banks or for shippers on railroads—who happens to have a claim against the debtor and also to owe something to the debtor to, in effect, prefer himself, because he can by setoff, in effect, get 100 percent on his claim, where other creditors are getting 10 percent.

Now, when it came to the railroads, the third circuit court of appeals in the *Penn Central* case affirmed an order of Judge Fulham which, one, enjoined all the banks which held Penn Central bank accounts

from setting off and, two, did just what you suggested, ordered those banks to continue to honor checks drawn on those accounts.

That one did not get to the Supreme Court. But another case got to the Supreme Court from the Penn Central reorganization. It is styled *Baker* v. *Gold Seal Liquors* and the Supreme Court held that the provision in the straight Bankruptcy Act, section 68 authorizing setoff's in straight bankruptcy, was not to be applied in railroad reorganization cases because it was inconsistent with the absolute priority rule, which is derived from the fair and equitable principle.

It seems to me that that ruling is also applicable to chapter X where we have the fair and equitable rule and to present chapter IX where we have the fair and equitable rule.

I thought that the automatic stay in this bill is an improvement over the automatic stays in the present bankruptcy rules because it does reach to setoff and none of those do reach to setoff.

It still does not answer the second question: after you have said to the bank you cannot set off, whether you can also say to the bank, as Judge Fulham did in the *Penn Central* case to keep on honoring checks.

Senator HRUSKA. Judge Patchan, have you anything to add to that?

Mr. PATCHAN. No, sir.

Senator HRUSKA. Well, we want to thank both of you again very, very much for coming. You have added greatly to the record and it will be highly useful.

The committee will adjourn now until Tuesday morning at 10 a.m. in room 6202.

[Whereupon, at 12:28 p.m. the committee recessed to reconvene at 10 a.m., Tuesday, November 4, 1975.]

ADJUSTMENT OF DEBTS OF POLITICAL SUBDIVISIONS AND PUBLIC AGENCIES AND INSTRUMENTALITIES

TUESDAY, NOVEMBER 4, 1975

U.S. SENATE,
SUBCOMMITTEE ON IMPROVEMENTS IN MACHINERY
JUDICIARY OF THE COMMITTEE ON THE JUDICIARY,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10:03 a.m., in room 6202, Dirksen Senate Office Building, Senator Quentin N. Burdick, presiding.

Present: Senators Burdick (presiding), and William L. Scott.

Also present: Thomas L. Burgum, deputy counsel; Robert E. Feidler, research director and counsel; Karen E. Krueger, secretary; and Harry Dixon, Senator Hruska's staff.

Senator BURDICK. Today we continue to hear testimony on S. 2597, a bill to amend the Bankruptcy Act. This bill purposes to add a new chapter XVI to remedy the inadequacies of chapter IX of the Bankruptcy Act.

At the time this legislation was introduced, I stated that I was not endorsing each and every provision but that I did consider this bill a good starting point for legislative consideration.

The testimony elicited at that hearing has strengthened my belief that this bill will provide a useful vehicle for the subcommittee and the Senate which will allow us to devise the best possible procedure should any municipality be compelled to seek debt reorganization in the bankruptcy court.

Our first witness today is Hon. James L. Buckley, Senator from New York.

STATEMENT OF HON. JAMES L. BUCKLEY, A U.S. SENATOR FROM THE STATE OF NEW YORK

Senator BUCKLEY. Thank you, Mr. Chairman.

Senator BURDICK. You are welcome to the committee.

Senator BUCKLEY. I thank you.

Mr. Chairman, I want to express my appreciation for the speed with which you have scheduled these hearings examining various proposals that I and the administration have introduced for amending the Bankruptcy Act of 1893 so as to permit insolvent municipalities to deal with their creditors in an orderly manner. This is not possible, as you know, under the existing law for the simple reason that so large a proportion of municipal obligations are in bearer form, thus making it impossible for a trustee for the insolvent municipality to identify and deal with all of its creditors.

88-838—77——17

The various proposals now under consideration address themselves to changes that ought to be legislated irrespective of New York City's present critical problems. The existence of those problems, however, make it absolutely essential that your committee act on an emergency basis so that the city can have the option of availing itself of the benefits and protections that the Bankruptcy Act offers to insolvent debtors. Because New York City may face the prospect of a default within the next 3 or 4 weeks, I urge that this subcommittee and the Judiciary Committee as a whole give this matter its highest priority.

Within the past 3 weeks, I have had the opportunity to review the results of the most recent audit of New York City's fiscal situation as well as the planned economies that have been submitted to, and demanded by, the Emergency Financial Control Board recently established by the New York State Legislature to oversee the city's management. The situation is even worse that I had been led to believe on the basis of earlier reports. The city's estimated deficit for the current fiscal year, ending June 30, 1976, has grown from an expected $600 to $900 million. Interest and principal obligations on the city's debt maturing between now and the end of the fiscal year will amount to more than $4 billion.

Despite heroic efforts by the State to help the city meet its ballooning obligations to its creditors, as well as this fiscal year's estimated operating deficit, it is clear that the city cannot continue to meet even its own essential services to its 8 million residents unless it either has massive infusions of money or credit, or unless it can exercise the option of filing a petition for voluntary receivership, and even then there will be a substantial gap that will need to be bridged.

To underscore my own feeling of urgency in this matter, Mr. Chairman, I would like to review, for a few moments, the alternatives, realistic and otherwise, that the city has available to it.

The first alternative is one suggested by President Ford in his speech at the National Press Club last Wednesday. He stated that between them, New York City and New York State have the ability to muster the capital with which to avert a default. This is an alternative that, in my judgment, the city and State must reject. Yes, my city and State have enormous resources but it would be reckless for them to attempt to mobilize them in order to meet maturing obligations to creditors. New Yorkers already have a significantly higher per capita State and local tax burden than any other State in the Union, and our economy is suffering from the effects as businesses look elsewhere when they want to build new plants. Because the State itself is having problems raising money in the credit market, the kind of financing that would be required for the city's benefit would require imposing new levels of taxes that in time would prove self-defeating.

The second alternative, and one that is by no means certain to be available, involved the availability of a Federal guarantee of city obligations. The Senate Banking Committee reported out, last week, a bill that would require the State to increase its contributions to the city, out of new taxes, by an estimated $425 million, in addition to paying a substantial fee, as much as $120 million the first year, for the Federal guarantee on New York City obligations. It would also require the city to negotiate reductions in interest on outstanding obligations and reductions in the city's contributions to various municipal

employee pension funds that as a practical matter probably could not be effected within the few days remaining before the city next faces the prospect of default.

Finally, the Senate proposal would impose the equivalent of an occupation army on the city in the form of a three-man Federal board having virtually unlimited power to dictate the most fundamental policies. This alone would require a widespread abdication of State and local authority that New Yorkers ought not to accept, and that the Congress ought not to enact because of the precedent it would set in eroding still further the line of demarcation between Federal authority on the one hand, and that of the States and localities on the other.

These are the prices that the Senate Banking Committee bill would extract in exchange for $4 billion in Federal guarantees, a figure that does not begin to be high enough to enable the city, even with an additional half a billion in State contributions, to ride out the next 2 years when it is predicted that the city's operating accounts will once again be in balance. Yet from all the evidence, this is probably the best that the city can expect in terms of congressional action between now and December 1.

If the State does not grant significant additional help, and if the Congress fails either to enact legislation to guarantee the city's obligations or to amend the Bankruptcy Act so that it can file a voluntary petition under it, the city will face a third alternative that could unleash chaos. Not only would it have to suspend all payments on interest and principal, but it would have a cash shortfall during December of more than $600 million. This means that it would not have the cash with which to meet its existing payrolls and welfare obligations. Such a situation would clearly prove dangerous, especially as creditors' suits could tie up much of the city's resources.

It is this possibility—and I would remind you, Mr. Chairman, that we are talking in terms of just a few weeks—that makes it essential that the Congress act on one or the other measures that are the subject of these hearings. For such action will provide the city with a fourth alternative, in my judgment the preferable alternative from the point of view of the interests of New York City's residents and taxpayers, namely, the option to file a petition under the Bankruptcy Act as amended, and thereby place the problem of working out the long-term funding of the city's huge $14 billion debt in the hands of a trustee or judge having the authority under the Constitution, (a) to restructure the city's debt, (b) to subordinate the claims of creditors to the paramount needs of the people of the city to uninterrupted delivery of essential services, and (c) to issue certificates of indebtness that can be given preferential claim on future revenues that are required to make them acceptable investments.

It is my personal belief and conviction, as I said in a statement I issued in New York City last Friday, that recourse to the remedies that would be provided under the legislation now before you would provide the city with the best opportunity to begin the huge job of placing itself back on its feet in an orderly manner. I believe that at this stage, it will be necessary for the Federal Government to cooperate with the court or trustee in order to assure the market for the certificates of indebtedness in the event their proir claim on the city's revenues should not prove sufficient to guarantee their saleability. I have a

specific proposal that addresses this matter that I will be introducing shortly; but as it is not relevant to the subject of these hearings, I shall not detail my thoughts.

I believe that when the options available to the city of New York are viewed unemotionally and are assessed realistically, it is clear that the fourth alternative must be made available at the earliest possible date so that plans can go forward with at least this option in mind. To do anything else would be utterly irresponsible.

As I stated earlier, you have before you several proposals, each of which has the same general objectives. You and your excellent staff are far more competent than I to determine which one is best designed to achieve these objectives, or whether features should be borrowed from each in the formation of a new bill. I would only urge that whatever it is you report out, it be made clear that the needs of the people be given first priority over the rights of any creditor. If a municipality is required to make the difficult but at times necessary decision to file a petition of voluntary insolvency, it must be absolutely clear that such an act on its part will not interrupt the continued delivery of essential services. I emphasize this point because some of the hysterical talk that has crept into the discussions of New York City's critical financial problems had led too many to assume that for the city to default would mean an interruption not only of police and fire services, but of welfare payments, sanitation services, and schooling as well.

In this connection, Mr. Chairman, I believe that my original bill, S. 2579, is deficient on the point. I believe that the matter is handled more explicitly in section 805(e) of the administration bill, and in section 403(a) of the second bill I introduced on behalf of Congressman Badillo of New York City, S. 2586.

I would also favor inclusion of the provisions of section 824(b)(2) in any final legislation which requires the municipality, in filing a plan with the court, to include a balanced budget after a period of time. I would say I prefer my section 804 to the administration's section 803(a), the latter requiring affirmative state approval in order to permit a city to file a petition. Mine states the other point of view, that unless the State law prohibits the filing by a municipality under the Bankruptcy Act, that it may do so.

I urge my language for the simple reason that it is not at all certain that there is time for the State to act in every situation.

Again, I want to thank you for the speed with which you have proceeded with this matter.

Senator BURDICK. Well, thank you, Senator, and thank you for your very good statement.

Yes, we have acted with speed, and we can report this from the subcommittee with speed, because we want to give New York another tool besides those which have been suggested.

Now, you didn't touch much on the mechanics of the bill itself. Have you read the contents of the bill that was introduced by Senator Hruska and myself?

Senator BUCKLEY. Yes, I have. And as I indicated in my statement, you are far more familiar as to what will work and will not work than I am, and I defer to your superior judgment.

Senator BURDICK. Well, I will just refer to one piece. As you recall, under the chapter of the Bankruptcy Act for municipalities, today

there is a requirement that 51 percent approve a plan at the time of filing, and it is not required in this case because the theory is that you want to give the court jurisdiction to start at once. You wouldn't object to that change?

Senator BUCKLEY. Certainly not, not as a practical matter. We have to make it possible for a State like New York to move under the act.

May I make one suggestion there? Once we move away from the idea of an absolute majority either in terms of amount or individuals that you might consider requiring of those who step forward that you have acquiescence of a majority both in terms of amount and in terms of individuals affected, because you do have a lot of small people who have invested in these securities, and I think it would not, in every instance, be equitable to allow a few banks to call the shots if they happen to possess the majority of the dollar value of a particular issue.

I might note, incidentally, that as I read the administration bill and the explanation of it, the bill itself I believe talked about amounts. The explanation talked about creditors.

Senator BURDICK. Well, I think the percentage that you referred to is in the approval of the plan.

Senator BUCKLEY. Right.

Senator BURDICK. I think the administration approach is it must be two-thirds of those voting. Does that meet with your approval?

Senator BUCKLEY. Of those voting or the dollars voting?

Senator BURDICK. It is a dollar amount.

Senator BUCKLEY. Dollars are not yet described as individuals. I notice there are certain bylaws that require the concept of both. In other words, both a majority of the individuals who hold the securities and a majority of the dollar value, and then I think this is something that you ought to consider, because I think it would assure maximum equity.

Senator BURDICK. Senator Scott?

Senator SCOTT. Mr. Chairman, I apologize for being late. It is good to have the views of my colleague from New York. I will certainly read his statement, but I have no questions.

Senator BUCKLEY. Thank you very much.

Senator BURDICK. Thank you very much.

Senator BUCKLEY. Thank you, Mr. Chairman.

Senator BURDICK. Mrs. Davis. Our next witness will be Miss Evelyn Y. Davis of New York. Mrs. Davis is the editor of Highlights and Lowlights of Annual Meetings, as well as a present bondholder of the State of New York.

STATEMENT OF EVELYN Y. DAVIS, EDITOR, HIGHLIGHTS AND LOWLIGHTS OF ANNUAL MEETINGS, NEW YORK CITY

Mrs. DAVIS. Right. And Mr. Chairman, I am also listed in Who's Who in America, and known as the Nation's leading minority stockholder. I believe in full disclosure. I am the owner of $15,000 of New York City general obligation bonds, $10,000 of New York State general obligation bonds, and one of those housing finance agencies, one of those questionable bonds, and also I have some municipal bonds in other States, notably the Commonwealth of Puerto Rico. So, I am giving you full disclosure.

As to the administration's plan, while it does have many excellent provisions and I predicted default as the only solution to the city's crises way ahead of any other person published on September 24, 1975 in a written statement before the Joint Economic Committee, it is unfortunate that no distinction was made between large and small bondholders. The great majority of city bondholders are small investors like myself, who are not millionaires, even though many of us are in high-income brackets. And I want to emphasize here that the banks are the ones, and the large investors are the ones that mainly do hold the short-term securities. I have asked this question at the bank annual meetings in March, and it was stated that they had very little, if any, long-term maturities. My maturities, as those of most small investors, are from 5 to 15 years.

We received false and misleading information from the city of New York, the banks, brokerage houses and other underwriters. Administration officials have stated that, "innocent parties will be protected." However, they made no mention whatsoever of us small investors.

We bought these issues with the provisions; "as to having first claim to the full taxing power of the city," a full faith and credit provision. Now we are being double-crossed and possibly "expropriated" and our rights as to the first claim are going to be given away to city employees.

Organized MAC bondholders which are mostly bank, corporations and other institutional investors are working hard to try to get preferential treatment for themselves, while we, the regular city bondholders with maturities of 5 to 15 years, do have a senior claim. And I wish to bring to your attention in today's New York Times and Wall Street Journal where a bank has filed suit as to this particular issue.

Now the administration wishes to propose a new debt certificate which would come ahead of our senior claims. This is a fraud against existing bondholders and who would buy those certificates, because in another year or two, they might come up with a still "newer" issue to take precedence over those issues. And who is going to have any more faith, in full faith and credit in securities. And the next thing that could happen could be to our U.S. Government obligations, which are backed by the full faith and credit of the U.S. Government. Who says that those securities are not going to be given away to the employees if something happens before the creditors?

And the rest of the municipal bond market may then collapse because other investors in the rest of the country would not trust ever this "First claim to the full taxing power of the city." Let the banks (they should have known better than to have invested stockholder funds in those bonds) take a moratorium on their short-term and long-term interest, but let the innocent private investors receive their interest temporarily though a Federal Reserve Bank branch as a loan to the city to be repaid by the city when it has made its necessary reductions in employment, has restructured its pension plans and eliminated free tuition at the city university, as well as has reduced its welfare payments by eliminating ineligibles. If the city bondholders do not receive their interest payments when due, the underwriters from whom they bought these issues will be bombarded with valid lawsuits. And it will be a fieldday for lawyers.

A Federal referee is a good idea, provided he does have public hearings which will include all bondholders who wish to express their views, not just bankers, politicians, lawyers, union leaders, and short term noteholders. And these bondholders can be identified through newspaper ads and can bring in a letter from their banks or brokers stating that they are owners of x number of bonds. Those who say they cannot identify the creditors, they never have even made an effort. They just don't wnat to be bothered with small investors. They only want to have the banks' points of view, the the banks are looking out for themselves with these bills at some other congressional committees, which are strictly for the benefit of the banks, for the 5-year durations, and then the banks are out and they don't care. And we, the small investors are, as usual, left holding the bag.

And there ought to be annual meetings for bondholders from now on, and the bondholders should elect independent accountants to check the city's books. Something like a board of directors.

And the city should be run for the time being by businessmen with proven ability with no interlocking ties to the banks. Retired chairmen of the board and presidents, and I have resolutions in proxy statements of many corporations (which some have adopted) as to the retirement conditions for executives and directors, might be suitable for teaching the city how to operate it as a business providing they have no ties to politicians or to the banks anymore. And the Senate must protect the small investors, the unorganized investors, because the banks and other institutional investors have always known how to look out for themselves, and all we have to do is read Highlights and Lowlights of Annual Meetings, and see to it that the MAC holders do not try to get preferential treatment for themselves. They have already taken claims that belong to us, the senior bondholders, and like I say, these new debt certificates, and if they are going to put those ahead of us, then that makes a whole mockery of full faith and credit, and nobody will buy any more municipal bonds. And this may also spill over into the stock market, into the Government securities market, and it might even be affecting the commercial banks, because people will not even trust the FDIC guarantee. They say you have nothing to worry about, you put your money in the banks, and you are secured for $40,000, but if the banks go broke, then maybe the money goes to the employees first too.

So, let the banks and other institutional investors take a moratorium on short- and long-term interest, but let the private investors receive their coupons through a Federal Reserve bank branch, and let there be ample opportunity for individual bondholders to reexpress their views, at any hearings.

As a New York City and New York State bondholder as well as a bondholder in some other State obligations and my name is known to most of our over 30 million investors, the only provision acceptable to bondholders would be a temporary reduction in interest rates.

And I want to thank you for giving me the opportunity to speak and you do have a balanced hearing that does include investors, and I will be glad to answer any questions that you may have.

Senator Scott [presiding]. I have no questions, Mrs. Davis, but it is nice that you could come and present your views to the committee. Thank you.

Mrs. DAVIS. Right. Does anybody else have questions? I would like to answer questions. Are you afraid of me?

Senator SCOTT. No. We will hear from Mr. King.

Mrs. DAVIS. All right. Thank you very much.

Senator SCOTT. Thank you very much for coming.

Our final witness is Dean Lawrence P. King. Dean King is the associate dean and professor of law at New York University School of Law. Dean King has written and lectured extensively in the field of creditors' rights. It is very good to have you with us at this time, Mr. King.

STATEMENT OF LAWRENCE P. KING, ASSOCIATE DEAN AND PROFESSOR OF LAW, NEW YORK UNIVERSITY LAW SCHOOL, NEW YORK CITY

Mr. KING. Thank you very much.

I would like to say at the outset that first I have prepared a short written statement which I would like to have incorporated in the record of the hearing.

Senator SCOTT. We are glad to include any statement, any reasonable statements in the record, and just have you proceed in your own manner.

[The prepared statement of Lawrence P. King in full follows:]

STATEMENT OF LAWRENCE P. KING

I am Associate Dean and Professor of Law at the New York University School of Law and of counsel to the New York City law firm of Wachtell, Lipton, Rosen & Katz. I have been teaching, writing and lecturing in the areas of creditors' rights and bankruptcy since approximately 1959. In addition to articles published in various law reviews, I am the revisions editor-in-chief of Collier on Bankruptcy, a multi-volume treatise covering all aspects of bankruptcy law and practice. While I am a member of the National Bankruptcy Conference, this statement is submitted by me individually and not as a representative of any group or organization. I served as a consultant to the Commission on the Bankruptcy Laws of the United States and since 1968, I have been an associate reporter for the Advisory Committee on Bankruptcy Rules of the Judicial Conference of the United States. My responsibilities as associate reporter consisted of drafting rules for Chapters IX, X, XI and XII of the Bankruptcy Act.

Chapter IX of the Act provides for the composition of indebtedness of taxing agencies and instrumentalities and is the subject of this statement and these hearings. The rules for Chapter IX have been published for comment by the bench and bar and, since the return date for such comment, were finally approved by the Advisory Committee at its meeting in July 1975. The Standing Committee on Rules of Practice and Procedure approved this set of rules in July 1975 and has, I understand, submitted the set to the Judicial Conference of the United States.

The bill, S. 2597, proposes to add a new Chapter XVI to the Bankruptcy Act rather than to amend present Chapter IX, which deals with the adjustment of municipal debt. The addition is necessitated by the fact that S. 2597 has limited applicability; that is, its provisions are limited to municipalities with a population in excess of one million inhabitants. I believe this feature of the bill is unsound and that present Chapter IX should be amended. A new chapter involving similar subject matter is neither necessary nor desirable.

One untoward effect of limiting the relief available under the Bankruptcy Act to the few largest cities in the United States is to make those cities immediately suspect. Regardless of current financial condition, the fact that they are singled out as entities which can more readily use a chapter proceeding can create an unfavorable aura with respect to the marketability of their securities. On the other hand, a single chapter applicable to all subdivisions of a state does not focus on individual entities and treats all alike. The change that is essential is by way of

amendment to present Chapter IX. Its requirements that a plan and acceptances by 51% in amount of claims be filed with the petition should be eliminated. Those requirements render Chapter IX unworkable.

The fact that a proceeding would be made easier to use does not militate against an overall amendment to Chapter IX and it does not argue for the addition of a new chapter. Whether or not a chapter proceeding is available to municipalities under the Bankruptcy Act is not important; the most telling factor is whether a municipality must default on its obligations. Existence or nonexistence of such a proceeding does not affect default; it will occur or not for other independent reasons.

The bill also requires that a good faith plan be filed with the petition to initiate a proceeding, together with a statement of revenues and expenditures adequate to show a balanced budget within a reasonable time. Historically, plans were required to be filed with petitions under Chapter XI of the Act and, until August 1, 1975, they were required under Chapter XII. That requirement has been eliminated in both types of cases. As a practical matter, it was found that prepetition plans served no purpose. In order to commence a proceeding, a plan would be prepared and filed but it bore little resemblance to the final proposal. There usually is insufficient time and data to prepare a meaningful plan. Moreover, the terms of a plan will ordinarily be negotiated with creditors. If municipalities were required to file a plan at such an early stage that very valuable process would not occur and valuable creditor input would be lacking, again making such a plan more illusory than practical.

An entity that needs relief from financial straits should be able to commence a proceeding seeking the adjustment of its debt structure with as little delay as possible and as few restrictions as possible.

The added provisions regarding the income and expenditures statement and balanced budget are also unnecessary and, perhaps, unwise. "Reasonable time" is not defined yet and in particular cases the words can create confusion and litigation. It will be inherent in the proceeding that a balanced budget is required, first to obtain creditor approval of a plan and second, to obtain court confirmation of a plan. To require figures representing that the budget will be balanced in the future does not, when the petition is filed, serve a useful purpose.

Section 806 permits the petition to be contested by creditors at any time up to ten days before the hearing on confirmation. While the concept is not unworkable, the bill should mandate such objections be filed very early in the proceeding as, for example, within a short period of time after the petition has been filed.

I would suggest the possibility that section 820 be deleted. It provides for special reference to a special master, referee in bankruptcy, or magistrate. Certainly "magistrate" should not be included. He has no special expertise in these matters whereas, at least, the referee in bankruptcy is much more qualified to Act. A special master, other than a referee, would presumably also be one with expertise in the particular area referred. If the provisions were deleted, the district judge could, in appropriate circumstances, use Rule 53 of the Federal Rules of Civil Procedure for the appointment of a special master.

Section 803 requires specific authorization by a state before an eligible municipality may file a petition under Chapter XVI. This would mean, I assume, that a previously granted general authorization would be insufficient; rather, authorization for the filing of the petition at the particular time is needed. This is another form of built-in-delay. One serious consequence, when relatively speedy action is required, would be that banks which are depositories of municipal funds may set-off such deposits. The state legislature may not be in session, differences of opinion may arise among legislators, other causes may create delay. At present, the law of New York State grants authority to the City of New York to file a petition under the federal Bankruptcy Act whether or not such Act should be amended in the future. Such prior consent or authorization should be sufficient and separate authorization not required.

The provision in section 811 with respect to debt certificates is taken from section 116 of Chapter X of the Act except for the final sentence. That sentence and the related provisions in section 805 (e) (the proviso clause) should be deleted. The bill should refrain from impinging on the political sovereignty of states and their subdivisions. Conditions attached to certificates of indebtedness will concern priority and lien status. These conditions, authorized by the court, will have the usual force of court orders and specific legislative directives

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to that end are unnecessary. The plenary jurisdiction provision in section 811 is unnecessary because section 801 (a) gives the court jurisdiction over the petitioner and its property for purposes of the chapter.

Mr. King. In addition to my teaching and writing and lecturing, I am a member of the National Bankruptcy Conference, and I served as a consultant to the Commission on Bankruptcy Laws of the United States. I am, however, appearing here today in my own behalf and not representing any group at all.

I have had an opportunity to review the administration's bill, which has been introduced in the House as S. 2597. I would like to direct some comments with respect to that bill which adds a chapter in the Bankruptcy Act, chapter XVI, for municipalities having populations in excess of 1 million.

First, I would like to indicate, as I have in the supplemental statement which I believe will be a part of this record——

Senator Scott. Professor, just so that we will be clear, you said introduced in the House. Are you talking about a different measure?

Mr. King. Did I say the House? I did not mean the House.

Senator Scott. Are you speaking now of the President's proposal?

Mr. King. Yes, I am.

Senator Scott. All right. Go right ahead, sir.

Mr. King. I didn't realize that I had said that.

Presently, in the Bankruptcy Act, chapter IX deals with the adjustment of municipal debts and, of course, when New York City got into its present financial crisis, and a few people began to look at the provisions of chapter IX, it became immediately apparent that that chapter is not a feasible working tool for a city such as New York.

The present filing conditions which that chapter requires make it virtually impossible for the city, any city, to commence a procedure under chapter IX. It requires that a plan be filed with the petition, and it also requires that acceptances by 51 percent in amount of claims of creditors also be filed with the petition.

For one thing, those two requirements take an awful lot of time to accomplish. And second, it is impossible, to get those acceptances particularly when the paper that is issued by the city is in bearer form and there is no information available with respect to the holders in order to obtain the acceptances.

The bills that are pending to amend chapter IX, I think, cure that defect. And I think that is a real defect. If there is to be any proceeding available to a municipality or to any other taxing authority, any subdivision of a State, it is apparent that the proceeding ought to be a feasible one. If such an entity needs some sort of a proceeding it ought to at least be possible for it to be able to get into court in the first place. Present chapter IX will not do that.

The administration's proposal would cure some of those defects, at least one of them. It would not require that acceptances of a plan be submitted with the petition commencing the proceedings under what that proposal calls for a chapter XVI. However, it does require that a plan be submitted with the petition, that it be a good faith plan and that a financial statement, in effect, be submitted which would indicate that within a reasonable time the city would have a balanced budget. That requirement of pre-preparation of a plan, I think, No. 1, is unnecessary, and No. 2, is unduly burdensome. There is no real need for such a plan at that early stage of a proceeding. The main objection

I would have to that is that it amounts to a lot of paperwork and doesn't accomplish any real purpose.

The plan that would be filed with the petition, I would venture to say, would just be one that was drawn up in a hurry and would have little resemblance to the eventual plan that would be proposed to the court and to the creditors.

Another defect that I find in this proposal is that it sets up a completely separate chapter. I don't think that it is necessary to have a chapter XVI, and I don't think that it is at all necessary to limit the provisions in this bill to the larger cities in the United States. If there is to be such a proceeding for the adjustment of municipal debt and debt of other taxing authorities and localities, the best approach would be to amend chapter IX and to put into the amendment those provisions which would make chapter IX more current, more usable and more logical.

One of the difficulties I would have, frankly, with the limitation in this chapter XVI for the larger cities is that it segregates out, it treats differently those larger cities. I don't know what the exact number would be, maybe six or something like that, and regardless of the present financial condition of all of those cities, I think it would make them immediately suspect. The fact would be that as to them there is available relief under a chapter of the Bankruptcy Act, but as to other cities having populations under one million there would, in effect, not be relief available, since it would still be extremely difficult if not impossible for them to use present chapter IX.

Overall, both legally and psychologically, it is much better to have one chapter which is applicable to all types of entities within the group of public entities.

There are a lot of other provisions in this proposal, some of which are sound, some of which start out in the right direction, but I think require a good deal of redrafting. Some of the sound proposals in this bill refer to the automatic stay that would occur on the filing of a petition to prevent actions in other courts against the city, which is absolutely essential.

One of the drafting problems that is inherent in this bill is that it would permit any creditor to object to the petition itself very late on in the proceedings, up to 10 days prior to confirmation. Any objection, if it should be allowed at all as to the filing of petition, should have to come very early on in the proceedings so that if the objection first of all was a sound one, then very early on, the petition can be dismissed. But if it is not sound, then the city, and the court and the creditors should not be under the gun during the entire process of the possibility of some creditor coming in and making such an objection, really whether it is a good one or not. But there has to be finality, it seems to me, with respect to the validity and propriety of the petition in the first place.

One of the little drafting problems that I have is with respect to the notice provision, the one requiring notices to be sent to creditors. I think that there should be a requirement set in there with respect to notice by publication. Certainly, the requirement should be that actual notice by mail should be given to those creditors where the names and the addresses are available, but where there are unknown creditors, there should be the requirement for publication in the hope of reaching those creditors. Otherwise, they may just not know

of the proceedings, of the various dates that are essential in the proceedings and of the rights that they may have with respect to the various events that take place in the proceedings.

Another sound proposal in this bill is the authority given to the issuance of, as is called, debtor certificates. Essentially, that provision is taken from chapter X of the Bankruptcy Act. I think there is some drafting problem with that particular section. It does not state as clearly as it should that if certificates are issued, they may be issued with priority over existing secured obligations. That is true presently in chapter X proceedings for corporate reorganizations under the Bankruptcy Act, and in order for it to have any real utility, whether or not it is used, that same authority ought to be in a chapter IX-type proceeding.

I think I have hit on perhaps the major issues that I wanted to talk about in my opening statement, and at this point I will submit myself to any questions that the subcommittee may have.

Senator Scott. Mr. King, it is good of you to be here and to share your thoughts on the subject that you have studied over the years and are knowledgeable about. I notice that you would prefer amendment of chapter IX rather than to have a new chapter written.

Now, would you care to expand on that in anyway?

Apparently, the new chapter for the larger cities, those over a million, is a desirable thing, and you seem to have a different view. And then you speak of this notice to be given to creditors and with publication notice.

Now, I have not studied the measure in detail. I have read the President's recommendation to the Congress, but isn't there within the general Bankruptcy Law provision for notice to be given to creditors by publication? Would any general provision of law apply to this chapter, or are you saying this chapter sort of stands alone without a procedural matter like that applying?

Mr. King. This chapter would essentially stand alone. Present chapter IX and this bill, and almost all of the pending legislation in this area that I have seen do not include provisions from other chapters of the Bankruptcy Act.

Now other chapters, for example chapter XI, chapter X, chapter XIII dealing with specific forms of relief for specific types of business and individual entities do include various provisions from the first seven chapters of the Bankruptcy Act. Chapter IX does not. Chapter IX is applicable sui generis. It is a different sort of proceeding, so that the present act in this version does not include anything like that.

Now, what has happened over the last few years is through the rule-making process, the Supreme Court of the United States and Congress have promulgated rules of procedure which apply to almost all of the chapters of the Bankruptcy Act. The rules with respect to chapter IX, however, although they have been drafted, and have been approved by the Advisory Committee, the Standing Committee on Rules of Practice and Procedure, and by the Judicial Conference of the United States, are presently pending before the Supreme Court of the United States, and I would suppose, if present or past practice is followed, they will be submitted to the Congress sometime after January. Those rules for chapter IX do provide various notices and

the form of notices and the requirements with respect to notices. But those are not yet in effect.

Present chapter IX does have a provision requiring publication of notices, particularly notice of the hearing that is to be held on the petition shortly after it is filed. I am only suggesting that as long as in the bill that is pending there is a provision with respect to notices, that it be clarified to indicate that publication should be mandatory for certain purposes, and for other purposes may be supplemental to written notice. It should not substitute for actual notice where the names and addresses of creditors are known.

Senator SCOTT. Mr. King, I believe that somewhere along the line, that basically the City of New York or any other city that might come under the provisions of this legislation, just as an individual must make some sort of an adjustment so that its income will be at least equal to its outgo. Now, do you feel that this proposal will tend to accomplish that so ultimately the City of New York can be operated, or any other city that would come under the provisions of this chapter, could be operated in a fiscally responsible manner so that its income would be equal, its receipts equal to its expenditures? Is there sufficient leverage here, or would you care to comment on this? To me, this is something that is essential, that somewhere along the line the city has to have enough revenue to pay its debts and to meet its expenditures, and to me this is a basic thing. And I just wonder, aside from the various provisions of the bill, is this going to accomplish the result of putting the City of New York on a fiscal basis? Should more leverage be in the bill, and if so what would you suggest?

Mr. KING. Well, I think the whole process, if one is available, would by its nature accomplish that purpose. There are two factors I think we tend not to be emphasizing as strongly as I think they should be emphasized. One is, and this is a basic starting point, the use of the Bankruptcy Act by anyone, and particularly a municipality, is really a last-ditch effort, a last resort. I think every other means of working out of a bad financial system ordinarily is tried, is attempted, so that we are starting from that point of view.

Second, within the proceeding itself, a factor that is not emphasized too strongly is that with respect to a chapter IX, similarly with respect to a chapter XI or chapter X, there is the negotiating process that goes on between the petitioner and the creditors, all of the creditors who are or will be affected by that proceeding. The petitioner does not have all of the leverage in the world. As a matter of fact, once there is a proceeding, the creditors have a great deal of leverage. While it is the petitioner's responsibility and privilege to propose a plan for the adjustment of the debt, whether it is by way of composition or by way of extension, or a combination of the two, it is also the creditors' right to accept or reject that plan.

The petitioner is not going to just automatically file the plan with the court and ask the court to send it out of creditors for vote. The petitioner will be in a long and very difficult negotiating process with the creditors before the provisions and the terms of that plan are actually worked out and actually written.

It is within that process that the creditors, it seems to me, perforce will insist on this balanced budget, this requirement which you think should come about and with which I agree. I don't know as I would

go so far as to put in specific provisions by legislative mandate. I think that No. 1, the same thing will be accomplished through the plan provision; and No. 2, there is this independent agency that exists, even after creditors have accepted the plan; the court must still confirm the plan, and must make independent findings before it can confirm the plan. One of these findings is that the plan must be fair and equitable.

This has certain meaning with respect to chapter I proceedings, where the language is also used, sort of an absolute priority rule, but that too, I think, incorporates within it the concept of a balanced budget.

I would say that if it were necessary to make this even more clear, I would add one other word as to the findings that the court must make; in addition to the findings that the plan is fair and equitable, that it must also find that the plan is feasible, that is, the provisions of the plan can be carried out in the future by the city out of the revenues obtained by the city, presupposing in the first instance a balanced budget. So that I think one, the requirement is necessary and, two, it can be found within the confines of these bills.

Senator Scott. Would you change the proposal in any way insofar as the State is concerned? Now, I ask this question thinking of the city as being a creature of the State, and is the State, should the State have any different responsibility than is provided in this bill, or should the city stand on its own city insofar as this proposal is concerned? Are you satisfied with the proposal insofar as the relationship with the State is concerned?

Mr. King. Well, I think I would add one or two things in it. I don't quite know how far I would go in that respect. I think the State should be involved. I think at the very least the State should be invited by the court. For example, in the chapter IX rules that I referred to, which are not yet the law, there is a provision requiring that notice be given, all of the notices that go to creditors also be given to the State so that No. 1, the State would have the notification and the knowledge of what is going on in the proceedings, but also by this method of giving the State notice, I think the State then would have the right to come in and intervene as it saw fit. I think that perhaps the bill might even be more specific in that regard, making the State a party in interest which, of course, would then automatically mean it has a right to be heard on any matters that come up in the proceedings. And I think by that method, the State then has the option of just how much it wants to get involved in the proceeding. I don't know as I would go so far as to make its involvement mandatory.

Senator Scott. Well, my thinking was roughly, and this was your statement we are talking about, not mine, but I was thinking that the city of New York is approximately one-half of the population, roughly one-half of the population of the State, and the financial situation in New York City would undoubtedly have an effect, good or bad, on the State. And the State we speak of as the sovereign entity, and the municipal corporations being created by the State, and I was just wondering if you might have any further comments with regard to the relationship of the State to this proposed legislation?

Mr. King. Well, referring to New York City specifically in that regard, I think they are under the New York State laws, that there would be a great deal of State involvement through whatever the

title, and I never could remember the exact title of this emergency control board or financial control board, that has been set up by the State legislature under a law that was enacted, I believe, last May, the emergency financial assistance law.

Even now that control board exerts an awful lot of power and authority over the mayor of the city of New York and the board of estimate.

Once there is a default in New York, which I would assume would precede the filing of any petition under the Federal Bankruptcy Act, if one is available, that board has or obtains even greater control over the fiscal affairs of the city. That board, I believe, is made up of more people from the State than from the city, so that the State representatives, or the Governor's representatives are on that board, and would have a great deal to say in such a proceeding. As a matter of fact, I think it would be one of the controlling forces within a proceeding under the Bankruptcy Act.

Senator Scott. Mr. King, once again I appreciate your being here and sharing your thoughts and your expertise in this field with us, and the responses that you have given to the questions.

Thank you, Mr. Chairman.

Senator Burdick. Is it desirable to require a plan to be filed with the petition?

Mr. King. I don't believe so, Mr. Chairman. I think there are two major difficulties with that requirement. One is that if the city, as any other entity, really must file a proceeding under the Bankruptcy Act, it normally has to do it within a very short period of time. I think a requirement that it must first sit down and prepare a plan just causes unnecessary delay.

And No. 2, I don't think that that plan really will serve any useful purpose whatsoever. It has been found in the past that where there were such requirements in other chapters of the Bankruptcy Act, a routine type or pro forma plan would be prepared. It has no resemblance whatsoever to the plan that would be forthcoming in the proceedings.

Finally, and perhaps equally important, maybe more important, is that a plan in a proceeding of this type is not just the product of the petitioner or the debtor, it is a plan that is negotiated, and negotiated in a very hard manner between the petitioner and the creditors.

If the city has to file along with the petition, there is not going to be that negotiating going on, and there is no indication that it would be satisfactory to the creditors. And also, and I am sure this applies to the city of New York, there would not, at that early stage, be sufficient data, sufficient information for the city to come up with any kind of a meaningful plan.

So in essence, what I am saying is that that is just extra paperwork which serves no real purpose, and I personally would not have that kind of a provision in the statute.

Senator Burdick. We were alerted last Friday at the hearings to another potential danger, and I would like to have your comment on it, that if it is required to present a plan that calls for a balanced budget within a reasonable time as a part of the petition, and then if some creditor would then challenge that petition, then it might affect the jurisdiction which you give to the bankruptcy court.

Mr. KING. Yes. As I read this proposal, I think that is a very sound objection. Two provisions have to be tied in together with that. One provision permits a creditor to object to the petition and seek dismissal of the proceedings at any time in the proceedings up to 10 days before the hearing on confirmation. Now, that can cover a long period of time, the hearing on confirmation can come 1, 2, 5 years after the petition has been filed. I would suppose that a form of objection could be, or a ground of objection could be that the plan certified to by the city when it filed the petition does not meet the fair and equitable test and, therefore, the court lacked the jurisdiction to entertain the petition and must dismiss.

Now, what happens if that is brought on very late in the proceeding is that all of the work that has been done in the proceeding first of all goes to waste. Second, the petitioner is then, in effect, thrown out on the street, and is not under any court supervision whatsoever.

Third, there may be some substantive law problems if, for example, the court has authorized the issuance of debtor certificates, with priorities of one form or another, and I would not venture a guess as to what would happen with the validity of those certificates, and yet creditors, certainly the lenders under those certificates have parted with their money and their financing. So the concept of first of all permitting a filing of an objection to the petition at such a late state, I think, is absolutely wrong.

If it is desirable, and it may be, to permit creditors to contest the good faith filing of a petition under this chapter, I think a strict limitation ought to be imposed on it, and the time limitation ought to expire very early in the proceeding, as, for example, perhaps 30 days after the filing of a petition. That is essentially the approach taken by the chapter IX rules. It is tied in, it is keyed into a different occurence, but the creditors may object to the petition, they may file an answer, it is called, to the petition under the proposed chapter IX rules, but the time to do so expires very shortly after the filing of the petition.

Senator BURDICK. Suppose we didn't require this balanced budget assertion at the time of the filing, that required it as a condition of the formulation of a plan instead. You would then avoid the jurisdictional question, wouldn't you, for the time being?

Mr. KING. Yes; that question would be avoided. Then you get into the substantive or the merits of that requirement of a balanced budget at whatever time. I frankly would prefer to use some language that is the Bankruptcy Act from other chapters, rather than inserting new language.

First of all, I am not an accountant or a financial expert, but I think there may be problems as to how one arrives at a balanced budget, financial data that is necessary and accounting methods and everything else. I wold prefer using the word "feasible," that the court, in order to confirm a plan, in addition to finding that it is fair and equitable, also find that it is feasible, meaning that, in effect, as to the best guess of the court and the creditors and the petitioner that the city will be able to perform its obligations in the future under the plan, and that will require projections of revenues and expenditures.

Senator BURDICK. If the plan is feasible, that envisions a balanced budget at some point?

Mr. KING. I would certainly think so, and as I say, I would prefer to use a word that has been in the statute for many years, maybe not

in chapter IX, but in other chapters. And a lot of these words over the years have taken the form of words of art at this point, and I just would be kind of leary of introducing new language, because then that starts the litigation process all over again.

Senator BURDICK. Well, whether in the original petition we can require the assertion that the plan is feasible or that the plan is a balanced budget and so forth, which might be jurisdictional, if we would remove that requirement from the petition and put it into the requirements for the adoption of a plan, then we issued some certificates of indebtedness, they wouldn't be subject to the challenge on jurisdiction.

Mr. KING. No. I certainly don't think there would be any challenge in that regard at that time, no, because the court will clearly have had jurisdiction of the proceedings during that entire process. If this is just decided at this late point, then I suppose there is no hope of consuming the plan, and that the proceedings ought to be dismissed.

Senator BURDICK. Wouldn't that be a preferable route to travel?

Mr. KING. I certainly would think so.

Senator BURDICK. We have had requirements in the past that plans in chapter cases were to be filed with a petition which had those requirements. Why have those requirements been dropped in the past?

Mr. KING. Well, it has been found that those requirements are essentially unworkable. It is just routine for a debtor's attorney to prepare any kind of a plan, file it with petition, because that was simply a requirement, so it was easy to meet the requirement, but there was no substance to the requirement.

Senator BURDICK. In other words, more or less a formality boiler plate?

Mr. KING. It was just a boiler plate, an absolute formality. As recently as August 1, 1975, with the effective date of the chapter XII rules, that requirement was dropped for purposes of chapter XII proceedings.

Senator BURDICK. When was that dropped, do you recall?

Mr. KING. Well, the rules themselves became effective August 1, 1975. And many years before, I don't have the exact date, that requirement was eliminated for chapter XI cases.

Senator BURDICK. Is there any provision anywhere in the present Bankruptcy Act or S. 235 or S. 236 requiring a debtor, public or private, to establish that his budget will be balanced before he can obtain relief?

Mr. KING. There is no provision that I know of any place else for such a requirement.

What does happen during the course of the proceeding is that in negotiating with creditors in other types of cases, chapter XI cases, chapter X cases, projections are made so that the creditors have some knowledge as to the validity, the proceedings and the desirability of the plan that is being proposed.

Senator BURDICK. If a city is to be required to establish that its budget will be balanced, in the absence of any standard method of accounting, is there any way of giving meaning to this requirement?

Mr. KING. I would doubt it very much. And what I could see is that at the very outset of the case, when the city needs all of the time available to work out its problems, and to start thinking about a plan, it is going to be tied up in litigation as to whether the proposal that it has

made with respect to the balanced budget is accurate, is inaccurate, or on the accounting methods that have been used and the like, and I think it is again unnecessarily burdensome.

Senator BURDICK. Section 806(a) provides that a creditor may file a complaint in a bankruptcy court contesting the petition for relief at any time up to 10 days before the hearing on confirmation of the plan. Do you think this is advisable?

Mr. KING. Well, the concept of permitting the creditors to contest a petition, perhaps on the good faith of a municipality or entity in filing, doesn't disturb me at all. That does exist even under present chapter IX. But, as I mentioned, the right to so contest the petition should be limited in time, and should have to come very early on in the proceedings.

Senator BURDICK. Then I would assume that 10 days before the hearing on confirmation would be too long a time?

Mr. KING. That would be much too long a time, and there is no reason at all for permitting it to go that far. Creditors certainly have the opportunity to make up their minds early on as to whether they want to protest the petition.

Senator BURDICK. Do you have a time in mind?

Mr. KING. I think at the outside 30 days after the filing of the petition would be sufficient. I have not found creditors, when they are so inclined, to take an awful lot of time in filing such objections.

Senator BURDICK. Do you think the provisions for debt certificate, section 811, is an adequate provision for maintenance of essential services during the process of reorganization of a municipality?

Mr. KING. It helps. I don't think it is totally adequate.

I think, for example, one of the matters that I have mentioned a little earlier is there may be a bit of a drafting problem with that provision. I think it should clearly provide that debt certificates may be issued assuming, of course, authorization from the court with priority over secured obligations. That provision does exist in the present chapter X of the act, and I would suggest that the provision from chapter X be carried over into this provision, hopefully chapter IX.

Now, I think on the merits though, on the substance of the provision, there may be some inadequacy. It provides the mechanism, it provides the possibility for the petitioner to issue debt certificates with the approval of the court. It does not, and it cannot provide for somebody purchasing those debt certificates or loaning money against them. That is something, that if it really is to be a valuable provision, I think probably has to come from other legislation, Federal legislation. In other words, should there be Federal guarantees of such certificates? I don't know the answer to that. But I am just talking about the practical, the legal aspects, as I suggested, which should be contained in this type of a bill.

Senator BURDICK. Section 811 provides that debt certificates can be issued upon good cause being shown. It has been suggested that the words "provide for the public health and safety" be substituted for "good cause". Which do you prefer?

Mr. KING. Well, I think I would stay with the cause. I would leave out the good. I think that is unnecessary. I don't know what "good" means, or good cause. I would use cause shown.

I have some difficulty with the words "for public health and safety." In one sense, that might be too narrow to cover all of what one might

think of as the essential services that the city should carry on. And if there is some problem with such coverage, then it puts the court in the position of trying to interpret around it, that something that may not quite fit public health and safety and yet it may be a type of essential service for which a certificate should be issued. And then the court has to play with that language, and perhaps come with a strained interpretation.

Frankly, I think that cause shown would serve essentially the same purpose, and perhaps provide the necessary discretion. I do not say an abundance of discretion, but the necessary discretion. That is, for services for which the city must maintain would be one finding and another finding, I think, for the issuance of certificates, certainly with priority over other claims and certainly with priority over secured, existing secured obligations, and the court would also have to find that there is no other source for such funds. And I think again we are talking about some case law interpretation that comes from other chapters which would be very useful in this type of a proceeding.

Senator BURDICK. In your opening statement, you recommend that the last sentence of section 811 be deleted. Would you elaborate as to why this provision might encroach on State sovereignty?

Mr. KING. Well, I have really looked at that provision a little more closely, and I have not had too much time to look at this whole bill; I have been out of town for the last 5 or 6 days, including the time when the administration's proposal was made by the President, but in looking at that more closely, I finally got the idea, at least I think I did, of what was intended by it. And that may be a problem in itself. I have a very simple mind, and I think this should be simply written so that some clarification would help.

I agree somewhat with its intended meaning, that after the close of a case with the debt certificates still outstanding, the court which had the proceeding before it retains jurisdiction on these debt certificates. It is too broadly written and may involve enforcement of terms other than payment. Since this may impinge on State sovereignty, unless the provision is strictly limited, it should be deleted. It is not necessary to have and can cause problems.

Senator BURDICK. Should debt certificates be given priority over administrative expenses?

Mr. King. Yes. I think the authority ought to exist for the certificates to be given such priority over administrative expenses, over secured obligations. Whether or not it will be used is a different question, but I think there ought to be the authority. As I suggested, it does exist in chapter XI, it exists under chapter X, and it does not seem to have been a real problem with the application of those provisions and they can at times be very useful.

Senator BURDICK. While the bill provides for modification of a plan before confirmation of a plan, no provision is made for confirmation of a plan or for amendment of a plan after confirmation. Wouldn't it be advisable to provide for amendment of a plan after confirmation, as is presently provided for in chapter X?

Mr. KING. I think so. I think that it would be helpful.

But even under chapter X, there is some limitation on that, which in essence, to my mind, makes me think that it is not a terribly important provision either way. Because under chapter X, a plan can be

modified after confirmation, but not after the plan itself has been substantially consummated, and the provisions—there is a provision in chapter X which defines a substantial consummation. Now, one of the elements which would constitute substantial consummation is that distribution under the plan has been commenced. Presumably, that is something that will occur after confirmation, so we are really talking about a short period of time.

Now, beyond that consummation, a plan, a modification which would alter the rights of creditors provided for in the plan would not be possible. A plan that would not so alter the rights of creditors would still be possible.

As I say, I don't have any problem with including such provisions in chapter IX. They may, in some sense, be helpful. I have, again, not seen that used very much in the chapter X proceedings.

Senator Burdick. In other words, this would not happen very frequently?

Mr. King. I do not think it would happen frequently at all.

Senator Burdick. Either the plan would be put into effect, or it would not, and if it were put into effect and you began to execute it, then it is too late?

Mr. King. That is correct.

Senator Burdick. So that is not a major point?

Mr. King. No, it is not a major point at all.

Senator Burdick. Do you believe the court should be left with the power to cancel labor contracts or pension plans where it determines they are too burdensome for the city?

Mr. King. I think it would be desirable to have a general provision in the statute permitting the petitioner to reject executory contracts with the approval of the court, and also after hearing or an opportunity for a hearing is given to the other contracting party, assuming that these are burdensome contracts.

This is a provision that has existed in other chapters of the Bankruptcy Act for a long time. It is in chapter X, it is in chapter XI, the authority or the power to reject executory contracts during the course of the proceeding, or in the plan that is proposed, accepted and confirmed. So it can be essentially a two-stage process.

I think it ought to exist with respect to chapter IX also. It is a very important provision. The other contracting party, should these be a rejection, would then become a creditor with a claim that can be proved in the proceedings.

important provision. The other contracting party, should there be a

Senator Burdick. I note that in the administration's proposal there is just one slight reference to executory contracts. I think it is to the effect that they may be rejected in the plan, and I think that itself ought to be changed. It should clearly say that executory contracts can be rejected during the course of the proceedings and also under the plan, and that specific provision be made as in other chapters of the act, the other contracting party after rejection becomes a creditor with a provable claim, because that party has to be protected.

Senator Burdick. Section 814(c) provides for classification of claims on the basis of source. Do you believe this to be a proper method of classification?

Mr. KING. Well, I think so. That may well take better minds than mine, since this gets into some financial aspects. These provisions come directly from present chapter IX, I believe, almost verbatim.

The problem would be how to classify claims, because I am not sure at the present time anybody has really focused on just what the lien rights may be with respect to the municipal bonds and notes that have been issued. But I would suppose it comes very close to classification along secured or unsecured lines, which is a basic form of classification. And then a third, in a business sense, would be a classification along any subordination provisions that might be contained. In the sense these provisions in the act come fairly close to that, there can't really be security by way of tangible property, and the closest you come to it is that there is the direction that the different pieces of paper may be paid from different sources of revenue. And I think a court, regardless of what this act would say, would have to make a determination as to whether those, in effect, create liens on those funds.

Senator BURDICK. Section 814 has a provision for confirmation of a plan by two-thirds of the affected voting creditors. Do you prefer this provision to the suggested 51 percent provided for in S. 235 and S. 236?

Mr. KING. I don't think I prefer it. I think I would prefer the 51 percent. On the other hand, I would settle for it.

Senator BURDICK. You would settle for what?

Mr. KING. I would settle for the two-thirds, although I think, as a matter of personal preference, I would go along with the 51 percent, as indicated in S. 235 and S. 236.

The reason for that is essentially, first of all, this would conform with what is being proposed in S. 235 and S. 236 for all kinds of business reorganizations. I think this represents the current thought of the people who have spent a lot of time in drafting those proposals, and I would, therefore, give a lot of credence to the conclusions that they have reached, that two-thirds may be an unnecessarily large percentage.

But, this is where I get to saying really that in essence it doesn't make all that much difference to me. Cosmetically, it may be better to use the 66⅔ vote because I don't think that whatever the vote, whatever the majority is would affect the bond market or anything else. It may have some psychological effect at some point in the future. If it is going to have that in terms of the marketability of the security, then it might well be worthwhile sticking with the two-thirds. Personally, I don't think it would have that effect.

At the present time, in view of the situation, if you put my back up against the wall, I would say we should retain the two-thirds and not yet go to the 51 percent.

Senator BURDICK. All right now, what we are talking about is two-thirds of 51 percent of what?

Mr. KING. OK. In any event, and particularly with respect to the two-thirds, it should be two-thirds of those creditors voting. One of the real difficulties that exists today in all chapter proceedings and a change was made in chapter X proceedings by the rules, is that whatever the percentage is required, whatever the majority required, they were computed on the basis of all filed and allowed plans. What this meant was if that a creditor filed a claim in a proceedings and did not

take the trouble to vote on the plan, just remained absolutely silent, that silence or that non-vote constituted a rejection of the plan, so that in order to obtain the acceptances, it was necessary to get the affirmative acceptances.

That created many problems. Now, in the revision of chapter X, procedurally by the rules, there was some slight change made there to indicate that the majorities required would be computed on the basis of those who vote on the plan, so that if one wanted to reject a plan, one would have to vote to reject the plan.

That provision is carried over in S. 235 and S. 236, and I think that that is absolutely essential in a chapter IX amendment.

Senator BURDICK. All right now, we have got it refined down to two-thirds or 51 percent of those voting. Again, of what?

Mr. KING. Well, it would have——

Senator BURDICK. Numbers, amounts?

Mr. KING. Oh, I am sorry. In this type of a situation, this type of a case, I would suggest that it would be the amount of claims, not in numbers of creditors. Again, it would be very, very similar—well, it would be the same as a chapter X corporate reorganization, which has the same provision where it is two-thirds, but it is two-thirds in amount, not counting the actual numbers of creditors. And it would be of those creditors affected by the plan. If one is not affected by the plan, there is no need for that creditor to be voting on the plan.

Senator BURDICK. Are the any other provisions in the law, in chapter X or in chapter XI requiring numbers?

Mr. KING. Chapter IX does. Chapter XI has as a twofold test. It is a majority in amount, and number of creditors. And at times that would make it difficult to confirm a plan in chapter XI. not because the plan is bad, or because there is an objection to the plan, but it is because there is lethargy among creditors who just fail to react when a plan is sent out.

In chapter XI today, the majority in number and in amount is based on all of the creditors who have filed claims and whose claims have been allowed. The amount normally is not a problem. It is at times a problem in obtaining a majority in number, because again, if a creditor does not vote, that constitutes a rejection. And if you need 51 percent in number, as I say, that can create some difficulty.

In chapter X, it is only by amount, and I think that the chapter IX provision should follow the chapter X. As a matter of fact, that is in the present chapter IX of the act, it is 51 percent in amount for filing and two-thirds in amount for confirmation.

Senator BURDICK. Then, as between two-thirds in amount, it is preferable that it be 51 percent of the amount and number?

Mr. KING. Two-thirds in amount would be much preferable to 51 percent in amount and number, yes, sir.

Senator BURDICK. Would you agree with the prior testimony that indentured trustees are incompetent to vote for a plan?

Mr. KING. Well, I don't know if I like the word incompetent.

Senator BURDICK. Should they?

Mr. KING. I think they may feel incompetent, as a matter of fact. Now, I don't think they should vote on a plan. I think that is up to the individual bondholders who are the actual creditors. They are the ones who should receive the notices, the plan, and who should have the right to vote. And frankly, I don't think indenture trustees

want to have all that power anyway, and I don't think it would be of benefit to the petitioner, to the debtor, to the whole course of the proceedings. I think that is a right that should remain with the bondholders, and not be given over to the indenture trustee.

Senator BURDICK. Do you think it is advisable to provide that a court can dismiss proceedings if it cannot confirm a plan? I wonder what other choice they have?

Mr. KING. Well, that is what I am trying to think. The one obvious choice that exists in other chapters is not applicable here, which is to adjudicate that they are a bankrupt, and you cannot adjudicate the city of New York a bankrupt.

I think if it comes down to that last point where nothing further can be done in the proceeding, the court should have the power to dismiss. I would hope that the statute providing such authority, that a court, if it could not confirm a plan for whatever reason, would give sufficient opportunity to the petitioner to come up with an amended plan, a different plan, a modified plan or the like, to see if that could carry confirmation through. If there had to be a dismissal, that obviously is not going to solve any problem.

Senator BURDICK. The bill contemplates that a Federal district judge will conduct the chapter proceedings. Some district judges, because of congestion of their docket or experience, may not be in as good a position as other district judges to conduct the proceedings. What are your thoughts as to amending the bill to provide that the chief judge of the appropriate circuit court of appeals should designate the district judge to conduct the chapter proceedings?

Mr. KING. Well, that would not disturb me at all. I think that there is some validity to that proposal. I would suppose that if that were not the case, and there were a regular assignment, of course this would then prevent that judge from taking other new cases, unless you were able to transfer some of the ones he already is handling, and that certainly could affect the docket.

I would make that discretionary. I don't think that I would make it mandatory, and if that is what they want to do in the local area, then that would be OK.

I have one other problem with respect to the proposed legislation, and it is somewhat related, but not altogether related, and that is the venue provision, which is in the proposed legislation, and which I did not mention in my opening statement. But, as I read the legislation, it would require, or it appears to require that, for example, if New York City had to file a petition, it would have to file in Brooklyn, the eastern district, rather than in Manhattan, the southern district.

Senator BURDICK. What would be wrong with that?

Mr. KING. Well, there is nothing essentially wrong with it, except for the fact that all of the executive offices, for example, are in the southern district and not in the eastern district. The courthouse is a lot closer to all of the executive offices. I don't personally care where it is filed. It seems to me that since New York City for example is located in two districts, it ought to have the option of filing in either place. And I would leave it up to the city, rather than making it mandatory in one place or the other.

Senator BURDICK. Banks who may be depositories of cities may also be bondholders. A set-off by banks of deposits against the amounts

due on the bonds would be automatically stayed by the filing of a petition. Could the plan of composition or extension provide that no set-offs would be allowed and that the city will be able to use the deposits for payments to all creditors?

Mr. King. Well, I think the plan can so provide. It wouldn't even disturb me if the bill were to have a specific provision in that regard. I don't think it is necessary, that there is any real vested right in the whole concept of set-off. It can exist or it cannot exist. So that I think the plan could so provide. There would, of course, have to be acceptance of the plan.

I think one of the difficulties with the present proposal is that the built-in delays which it contains with respect to the filing of the petition could have the effect of enabling banks to set-off before this automatic stay becomes operative. For example, the provision in the administration's proposal that the city obtain specific State authorization before it can file the petition means, I assume, that the State legislature would have to be called into session, if it is not presently sitting, that a bill would have to be passed authorizing the city to file a petition, and while all of this is going on, the banks can be operating to set-off the deposits that they have on hand, even though there is State legislation right now which expressedly authorizes the City of New York to file the petition under the Federal Bankruptcy Act.

Senator Burdick. How do we treat this subject in chapters X and XI?

Mr. King. With respect to set-offs?

Senator Burdick. Yes.

Mr. King. In chapters X and XI, we start with the proposition that the set-off provision, which is contained in the first seven chapters, section 68 of the Bankruptcy Act, permits this kind of a setoff, prebankruptcy, not postbankruptcy. Once there is a bankruptcy, if the set-off has not been exercised, then that property becomes property of the estate.

Senator Burdick. That doesn't happen very often, does it?

Mr. King. I am hesitating a bit, because there is a little case law that has been growing up now, starting from seciton 77 providing for the railroad reorganization proceedings, which says that the court has the authority to prevent the setoff and to reverse a prebankruptcy setoff, so that the debtor can use the funds. Normally, what happens judicially is something that is good for the railroad reorganization is also good for chapter X, so that could be the next step and then the third step is that if it is good for chapter X, it is also good for chapter XI. And that is the way that the courts sometimes move. So it is difficult to say.

As far as the provisions in the statute are concerned, there isn't anything directly to the effect that the court can stay the setoff if it had occurred before the petition. Once the petition is filed, and the setoff had not occurred, then that would become property of the estate, and delay the exercise of setoff in X and XI.

Senator Burdick. Well, we can make the provision as we see fit, in other words.

Mr. King. I would think so. And I would believe, as a matter of fact, that there are provisions in S. 235 and 236 in chapter VII in one, and I think maybe it is chapter IV in the other, with respect to

the restraining setoff, and while I think they require some adequate protection, I am not sure that that is absolutely necessary.

Senator BURDICK. There may be many contests following the filing of a petition as to the jurisdiction of the court. Would a finding of jurisdiction upon these contests be an appealable order? If so, in the intertests of the prompt progression of the plan, should the bill provide that a finding of jurisdiction is not an appealable order?

Mr. KING. I would assume that a finding—well, I am trying to remember my Federal appellate rules and the case law in that regard, whether this is a final order. I guess it is not a final order, because that could be taken up later in the proceedings.

The difficulty in this chapter proceedings and the like is that it is not like an ordinary civil litigation where at some point there is going to be a final judgment. There are many orders issued, contested orders issued in a chapter proceeding which bear on some legal, substantive rights, and if one had to wait until the end of the proceedings, then many of the questions would, of course, become moot.

I would think that this would be an unappealable order, and whether the bill could, in effect, make it non-appealable. I suppose it could, but I wouldn't want to take a firm stand on that. That is a legal issue that I just have not researched.

Senator BURDICK. Well, harking back to my law school days, jurisdiction was a special category, it could be raised most any time, and raised in any court.

Mr. KING. Well, if we are talking about subject matter jurisdiction, I think that is right. That can be raised at any time, and it can be raised collaterally, I suppose.

I would find it very difficult, if this bill were properly drafted; that is, properly, in my opinion, that there would really be anything of subject matter jurisdiction type, essentially.

Senator BURDICK. Well, for example, in the petition we talked about a while ago, if the petition should require that at the time of the filing of the petition that you should also, or there should also be a plan filed that would envision an approved and a balanced budget within x number of years, and if that was part of the petition and a necessary requirement, that might be found to be unworkable, but found that those factors had to be present before the court had jurisdiction to operate subsequently.

Mr. KING. Right. I agree with you.

Senator BURDICK. And that could be appealed, could it not?

Mr. KING. That is right. And I agree with you that those would be jurisdictional. But what I was saying was that I would hope, strongly and sincerely, that those would not be part of any bill that was enacted.

Senator BURDICK. Well, it is part of the bill before us.

Mr. KING. That is right, and I would hope that that would be deleted. That is another reason why I think that they should be deleted.

Senator BURDICK. Well, you have answered this question of whether or not the jurisdictional question is an appealable order, that you think it might be, that you are not sure.

Mr. KING. I think that would be an appealable order, yes.

Senator BURDICK. Pardon?

Mr. KING. I think it would be an appealable order.

Senator BURDICK. But, could we prevent it from being?

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Mr. KING. Well, that is the one I really don't know and prefer not to take a stand on.

Senator BURDICK. All right. In S. 2579, which is commonly known as the Buckley bill, it provides for the rejection of executory contracts. To what extent are pension benefits for municipal employees executory contracts?

Mr. KING. Well, that's a question that raises in part, at least, to whether the term executory contract can be defined. And I think some very good minds have attempted definitions and have not, at least, been able to put them in any statute. I would think that it would have to be broken down into two respects. One, with respect to contributions that are ongoing with respect to employees, that those would be in the form of executory contracts, because there is something to be done by both parties to that contract. Theoretically, I suppose that a pension benefit for employees who are no longer working and are entitled to those benefits. Those would not be executory contracts.

Now, if they come out of general revenues, just using that as an example for these types of payments, then it would be like other types of claims against the city which would not be paid, and they would be classified as unsecured claims. And when we are talking about executory contracts, that is the effect, that if the contracts can be rejected and is, in fact, rejected of a party, then the other party to the contract becomes a general creditor for the breech of that contract, so in that general sense.

Now, this also may be for some good reason, and perhaps litigation in this specific case of New York City, I don't know for sure, for example, whether there are some constitutional provisions or which there might be, which make mandatory certain payments which, therefore, would take this sort of thing out of the nature of a contract and, therefore, perhaps provide or not permit such rejection. And I have heard people talk along this line, but very few people have actually researched it, to find out if this is the fact, so I was speaking very generally on that.

Senator BURDICK. Well, the pension plan that has ripened, and the man is no longer employed, that is no longer executory.

Mr. KING. That would no longer be executory. On the other hand, I don't know how these are set up in terms of the funds, but if these are set up as specific funds managed by somebody for this sole purpose, they may also not be funds that become a part of the estate in a proceeding, and so these would continue to be paid. It may not be possible to continue to making contributions.

Senator BURDICK. What about a pension plan where certain portions of it had vested, part of it was executed and part of it was executory?

Mr. KING. I would venture a guess there that in terms of present law, under other chapters, an executory contract cannot be rejected or assumed in part.

Senator BURDICK. I see. That answers that.

Are there any more questions? Well, I guess we have exhausted our file of questions and we want to thank you, Mr. King, for being very helpful to the committee. We appreciate it.

Mr. KING. Thank you very much, Mr. Chairman.

Senator BURDICK. The meeting is adjourned.

[Whereupon, at 11:40 a.m., the hearing was adjourned, subject to the call of the Chair.]

APPENDIX

Public Law 94-260
94th Congress, H. R. 10624
April 8, 1976

An Act

To amend chapter IX of the Bankruptcy Act to provide by voluntary reorganization procedures for the adjustment of the debts of municipalities.

Whereas the Congress finds and declares this Act and proceedings thereunder providing for the composition of indebtedness of, or authorized by, municipalities to be within the subject of bankruptcies under article I, section 8, clause 4 of the United States Constitution; and

USC prec title 1.

Whereas the Congress finds that the impracticability of existing Federal bankruptcy remedies for use by municipalities increases the likelihood of their default and will aggravate the adverse effects thereof; and

Whereas the Congress finds that the financial disruptions and dislocations resulting from default of such municipalities without availability of a Federal procedure to restructure their indebtedness in such fashion as to avoid continuing insolvency would have a substantial adverse effect on interstate commerce within the meaning of article I, section 8, clause 3 of the United States Constitution, by reason of the commercial importance of the municipalities involved.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That chapter IX of the Bankruptcy Act is amended to read as follows:

Bankruptcy Act, amendments. 11 USC 401 et seq.

"CHAPTER IX

"ADJUSTMENT OF DEBTS OF POLITICAL SUBDIVISIONS AND PUBLIC AGENCIES AND INSTRUMENTALITIES

"SEC. 81. CHAPTER IX DEFINITIONS.—As used in this chapter the term— 11 USC 401.

"(1) 'claim' includes all claims of whatever character against the petitioner or the property of the petitioner, whether or not such claims are provable under section 63 of this Act and whether secured or unsecured, liquidated or unliquidated as to amount, fixed or contingent; 11 USC 103.

"(2) 'court' means court of bankruptcy in which the case is pending, or a judge of such court;

"(3) 'creditor' means holder (including the United States, a State, or political subdivision or public agency or instrumentality of a State) of a claim against the petitioner;

"(4) 'claim affected by the plan' means claim as to which the rights of its holder are proposed to be materially and adversely adjusted or modified by the plan;

"(5) 'debt' means claim allowable under section 88(a);

"(6) 'lien' means security interest in property, lien obtained on property by levy, sequestration, or other legal or equitable process, statutory or common law lien on property, or any other variety of charge against property to secure the performance of an obligation;

"(7) 'person' includes a corporation or a partnership, the United States, the several States, and political subdivisions and public agencies and instrumentalities of the several States;

"(8) 'petitioner' means agency, instrumentality, or subdivision which has filed a petition under this chapter;

"(9) 'plan' means plan filed under section 90;

"(10) 'special tax payer' means record owner or holder of title, legal or equitable, to real estate against which has been levied a special assessment or special tax the proceeds of which are the sole source of payment of obligations issued by the petitioner to defray the costs of local improvements; and

"(11) 'special tax payer affected by the plan' means special tax payer with respect to whose real estate the plan proposes to increase the proportion of special assessments or special taxes referred to in paragraph (10) of this section assessed against that real estate.

11 USC 402. "SEC. 82. JURISDICTION AND POWERS OF COURT.—

"(a) JURISDICTION.—The court in which a petition is filed under this chapter shall exercise exclusive original jurisdiction for the adjustment of the petitioner's debts, and for the purposes of this chapter, shall have exclusive jurisdiction of the petitioner and its property, wherever located.

"(b) POWERS.—After the filing of a petition under this chapter the court may—

Notice, hearing. "(1) permit the petitioner to reject executory contracts and unexpired leases of the petitioner, after hearing on notice to the parties to such contracts leases and to such other parties in interest as the court may designate;

Notice, hearing. "(2) during the pendency of a case under this chapter, or after the confirmation of the plan if the court has retained jurisdiction under section 96(e), after hearing on such notice as the court may prescribe and for cause shown, permit the issuance of certificates of indebtedness for such consideration as is approved by the court, upon such terms and conditions, and with such security and priority in payment over existing obligations, secured or unsecured, and over costs and expenses of administration, not including operating expenses of the petitioner, as in the particular case may be equitable; and

"(3) exercise such other powers as are not inconsistent with the provisions of this chapter.

"(c) LIMITATION.—Unless the petitioner consents or the plan so provides, the court shall not, by any stay, order or decree, in the case or otherwise, interfere with—

"(1) any of the political or governmental powers of the petitioner;

"(2) any of the property or revenues of the petitioner; or

"(3) the petitioner's use or enjoyment of any income-producing property.

"(d) DESIGNATION OF JUDGE.—After the filing of a petition, the chief judge of the court in the district in which the petition is filed shall immediately notify the chief judge of the circuit court of appeals of the circuit in which the district court is located, who shall designate the judge of the district court to conduct the proceedings under this chapter.

11 USC 403. "SEC. 83. RESERVATION OF STATE POWER TO CONTROL GOVERNMENTAL FUNCTIONS OF POLITICAL SUBDIVISIONS.—Nothing contained in this chapter shall be construed to limit or impair the power of any State

to control, by legislation or otherwise, any municipality or any political subdivision of or in such State in the exercise of its political or governmental powers, including expenditures therefor: *Provided, however*, That no State law prescribing a method of composition of indebtedness of such agencies shall be binding upon any creditor who does not consent to such composition, and no judgment shall be entered under such State law which would bind a creditor to such composition without his consent.

"SEC. 84. ELIGIBILITY FOR RELIEF.—Any State's political subdivision or public agency or instrumentality, which is generally authorized to file a petition under this chapter by the legislature, or by a governmental officer or organization empowered by State law to authorize the filing of a petition, is eligible for relief under this chapter if it is insolvent or unable to meet its debts as they mature, and desires to effect a plan to adjust its debts. An entity is not eligible for relief under this chapter unless— **11 USC 404.** **Conditions.**

"(1) it has successfully negotiated a plan of adjustment of its debts with creditors holding at least a majority in amount of the claims of each class which are claims affected by that plan;

"(2) it has negotiated in good faith with its creditors and has failed to obtain, with respect to a plan of adjustment of its debts, the agreement of creditors holding at least a majority in amount of the claims of each class which are claims affected by that plan;

"(3) such negotiation is impracticable; or

"(4) it has a reasonable fear that a creditor may attempt to obtain a preference.

"SEC. 85. PETITION AND PROCEEDINGS RELATING TO PETITION.— **11 USC 405.**

"(a) PETITION.—An entity eligible under section 84 may file a petition for relief under this chapter. In the case of an unincorporated tax or special assessment district having no officials of its own, the petition may be filed by its governing authority or the board or body having authority to levy taxes or assessments to meet the obligations of the district. Any party in interest may file an answer to the petition with the court, not later than 15 days after the publication of notice required by subsection (d) is completed, objecting to the filing of the petition. Upon the filing of such an answer, the court may dismiss the petition after hearing on notice if the petitioner did not file the petition in good faith, or if the petition does not meet the requirements of this chapter. The court shall not, on account of an appeal from a finding of jurisdiction, delay any proceeding under this chapter in the case in which the appeal is being taken; nor shall any court order a stay of such proceeding pending such appeal. The reversal on appeal of a finding of jurisdiction shall not affect the validity of any certificate of indebtedness authorized by the court and issued in such case. **Notice, publication.** **Notice, hearing.**

"(b) LIST.—The petitioner shall file with the court a list of the petitioner's creditors, insofar as practicable. The list shall include for each known creditor, to the extent practicable, the name of the creditor, the address of the creditor so far as known to the petitioner, and a description of any claim of the creditor, showing the amount and character of the claim, the nature of any security for the claim, and whether the claim is disputed, contingent or unliquidated as to amount. If an identification of any of the petitioner's creditors is impracticable, the petitioner shall state the reason such identification is impracticable and the character of the claims of the creditors involved. The petitioner shall supplement the list as creditors who were unknown or unidentified at the time the list was filed become known or identified to the petitioner. If the list is not filed with the petition, the petitioner shall file the list at such later time as the court, upon its own motion or upon application of the petitioner, sets.

"(c) VENUE AND FEES.—The petition and any accompanying papers, together with a filing fee of $100, shall be filed with a court in a district in which the petitioner is located.

"(d) NOTICE.—The petitioner or such other person as the court designates shall give notice of the filing or dismissal of the petition to the State in which the petitioner is located, to the Securities and Exchange Commission, and to creditors included in the list of creditors required by subsection (b) or in any supplement to that list. The notice shall also state that a creditor who files with the court a request, setting forth that creditor's name and address and the nature and amount of that creditor's claim, shall be given notice of any other matter in which that creditor has a direct and substantial interest. The notice required by the first sentence of this subsection shall be published at least once a week for three successive weeks in at least one newspaper of general circulation published within the jurisdiction of the court, and in such other papers having a general circulation among bond dealers and bondholders as may be designated by the court. The court may require that it be published in such other publication as the court deems proper. The court shall require that a copy of the notice required by the first sentence of this subsection be mailed, postage prepaid, to each creditor named in the list required by subsection (b) at the address of such creditor given in the list, or, if no address is given in the list for a creditor and the address of such creditor cannot with reasonable diligence be ascertained, then a copy of the notice may, if the court so determines, be mailed, postage prepaid, to such creditor addressed as the court may prescribe. All expense of giving notice required by this subsection shall be paid by the petitioner, unless the court for good cause determines that the cost of notice in a particular instance should be borne by another party. The notice shall be first published as soon as practicable after the filing of the petition, and the mailing of copies of the notice shall be completed as soon as practicable after the filing of the list required by subsection (b).

Publication in newspapers.

"(e) STAY OF ENFORCEMENT OF CLAIMS AGAINST PETITIONER.—

"(1) EFFECT OF FILING A PETITION.—A petition filed under this chapter shall operate as a stay of the commencement or the continuation of any judicial or other proceeding against the petitioner, its property, or an officer or inhabitant of the petitioner, which seeks to enforce any claim against the petitioner, or of an act or the commencement or continuation of a judicial or other proceeding which seeks to enforce a lien upon the property of the petitioner or a lien on or arising out of taxes or assessments due the petitioner, and shall operate as a stay of the enforcement of any set-off or counterclaim relating to a contract, debt, or obligation of the petitioner.

"(2) DURATION OF AUTOMATIC STAY.—Except as it may be terminated, annulled, modified, or conditioned by the court under the terms of this subsection, the stay provided for in this subsection shall continue until the case is closed or dismissed, or the property subject to the lien is, with the approval of the court, abandoned or transferred.

Hearing.

"(3) RELIEF FROM AUTOMATIC STAY.—Upon the filing of a complaint seeking relief from a stay provided for by this section, the court shall set a hearing for the earliest possible date. The court may, for cause shown, terminate, annul, modify, or condition such stay.

"(4) OTHER STAYS.—The commencement or continuation of any other act or proceeding may be stayed, restrained, or enjoined by the court, upon notice to each person against whom such order would apply, and for cause shown. The court may issue an order under this paragraph without requiring the petitioner to give security as a condition to that order.

"(f) UNENFORCEABILITY OF CERTAIN CONTRACTUAL PROVISIONS.—A provision in a contract or lease, or in any law applicable to such a contract or lease, which terminates or modifies, or permits a party other than the petitioner to terminate or modify, the contract or lease because of the insolvency of the petitioner or the commencement of a case under this chapter is not enforceable if any defaults in prior performance of the petitioner are cured and adequate assurance of future performance is provided.

"(g) RECOVERY OF SET-OFF.—Any set-off which relates to a contract, debt, or obligation of the petitioner and which set-off was effected within four months prior to the filing of the petition, is voidable and recoverable by the petitioner after hearing on notice. The court may require as a condition to recovery that the petitioner furnish adequate protection for the realization by the person against whom or which recovery is sought of the claim which arises by reason of the recovery.

"(h) AVOIDING POWERS.—Sections 60a, 60c, 67a, 67d, 70c, 70e(1), and 70e(2), and the first three sentences of section 60b shall apply in cases under this chapter as though the petitioner were the bankrupt, debtor, or trustee. If the petitioner refuses to pursue a cause of action under a section or sentence made applicable to this chapter by this subsection, the court may, upon the application of any creditor, appoint a trustee to pursue such cause of action.

11 USC 96, 107, 111.

"SEC. 86. REPRESENTATION OF CREDITORS.—

11 USC 406.

"(a) REPRESENTATION AND DISCLOSURE.—Any creditor may act in that creditor's own behalf or by an attorney or a duly authorized agent or committee. Every person, not including governmental entities, representing more than one creditor shall file with the court a list of the creditors represented by such person, giving the name and address of each such creditor, together with a statement of the amount, class, and character of the claim held by that creditor, and shall attach to the list a copy of the instrument signed by the holder of such claim showing such person's authority, and shall file with the list a copy of the contract or agreement entered into between such person and the creditors represented by that person. Such person shall disclose all compensation incident to the case, received or to be received, directly or indirectly, by that person. That compensation shall be subject to modification and approval by the court.

"(b) MULTIPLE COMPENSATION.—The court shall examine all of the contracts, proposals, acceptances, deposit agreements, and all other papers relating to the plan, specifically for the purpose of ascertaining if any person, not including governmental entities, promoting the plan, or doing anything of such a nature, has been or is to be compensated, directly or indirectly, by both the petitioner and any of its creditors, and shall take evidence under oath to determine whether any such compensation has occurred or is to occur. After such examination the court shall make an adjudication of this issue, and if it be found that any such compensation has occurred or is to occur, the court shall dismiss the petition and tax all of the costs against the person promoting the plan or doing anything of such a nature and receiving such

multiple compensation, or against the petitioner, unless such plan is modified, within the time to be allowed by the court, so as to eliminate the possibility of such compensation, in which event the court may proceed to further consideration of the confirmation of the plan.

11 USC 407. "SEC. 87. REFERENCE, EXPENSES, AND JOINT ADMINISTRATION.—

"(a) REFERENCE.—The court may refer any special issue of fact to a referee in bankruptcy for consideration, the taking of testimony, and a report upon such special issue of fact, if the court finds that the condition of its docket is such that it cannot take such testimony without unduly delaying the dispatch of other business pending in the court, and if it appears that such special issue is necessary to the determination of the case. A reference to a referee in bankruptcy shall be the exception and not the rule. The court shall not make a general reference of the case, but may only request findings of specific facts.

"(b) EXPENSES.—The court may allow reasonable compensation for the actual and necessary expenses incurred in connection with the case, including compensation for services rendered and expenses incurred in obtaining the deposit of securities and the preparation of the plan, whether such work has been done by the petitioner or by a representative of creditors, and may allow reasonable compensation for an attorney or agent of any of them. No fee, compensation, reimbursement, or other allowances for an attorney, agent, or representative of creditors shall be assessed against the petitioner or paid from any revenues, property, or funds of the petitioner except in the manner and in such sums, if any, as may be provided for in the plan. An appeal may be taken from any order allowing compensation to the United States court of appeals for the circuit in which the case under this chapter is pending, independently of any other appeal which may be taken in the case. The court of appeals shall hear and determine such appeal summarily.

"(c) JOINT ADMINISTRATION.—If two or more petitions by related entities are pending in the same court, the court may order joint administration of the cases.

11 USC 408. "SEC. 88. CLAIMS.—

"(a) ALLOWANCE OF CLAIMS.—In the absence of an objection by a party in interest, or of a filing of a proof of claim, the claim of a creditor that is not disputed, contingent, or unliquidated as to amount, and that appears in the list or in a supplement to the list filed by the petitioner under section 85(b) shall be deemed allowed. The court may set a date by which proofs of other claims shall be filed. If the court does not set a date, such proofs of other claims shall be filed before the entry of an order confirming the plan. Within thirty days after the filing by the petitioner of the list or any supplement to the list under section 85(b), the court shall give written notice to each person whose claim is listed as disputed, contingent, or unliquidated as to amount, informing each such person that a proof of claim must be filed with the court within the time fixed under this subsection. If there is no objection to such claim, the claim shall be deemed allowed. If there is an objection, the court shall hear and determine the objection.

Written notice.

"(b) CLASSIFICATION OF CREDITORS.—The court shall designate classes of creditors whose claims are of substantially similar character and the members of which enjoy substantially similar rights, consistent with the provisions of section 89, except that the court may create a separate class of creditors having unsecured claims of less than $250 for reasons of administrative convenience. If there is a controversy over the classification of a creditor, the court shall, after hearing on notice, summarily determine such controversy.

Hearing, notice.

"(c) Damages upon rejection of executory contracts.—If an executory contract or an unexpired lease is rejected under the plan or under section 82(b), any person injured by such rejection may assert a claim against the petitioner. The rejection of an executory contract or unexpired lease constitutes a breach of the contract or lease as of the date of the commencement of the case under this chapter. The claim of a landlord for injury resulting from the rejection of an unexpired lease of real estate or for damages or indemnity under a convenant contained in such lease shall be allowed, but shall be limited to an amount not to exceed the rent, without acceleration, reserved by such lease for the year next succeeding the date of the surrender of the premises to the landlord or the date of reentry of the landlord, whichever first occurs, whether before or after the filing of the petition, plus unpaid accrued rent, without acceleration, up to the date of such surrender or reentry. The court shall scrutinize the circumstances of an assignment of a future rent claim and the amount of the consideration paid for such assignment in determining the amount of damages allowed the assignee of that claim.

"Sec. 89. Priorities.—The following shall be paid in full in advance of any distribution to creditors under the plan, in the following order: 11 USC 409.

"(1) The costs and expenses of administration which are incurred subsequent to the filing of a petition under this chapter.

"(2) Debts owed for services or materials actually provided within three months before the date of the filing of the petition under this chapter.

"(3) Debts owing to any person, which by the laws of the United States (other than this Act) are entitled to priority.

"Sec. 90. Filing and Transmission of Plan and Modifications.— 11 USC 410.

"(a) Filing.—The petitioner shall file a plan for the adjustment of the petitioner's debts. If such plan is not filed with the petition, the petitioner shall file the plan at such later time as the court, upon its own motion or upon application of the petitioner, sets. At any time prior to the confirmation of a plan, the petitioner, or any creditor, if the petitioner has consented in writing to the modification to be filed by the creditor, may file a modification of the plan; but the modification shall comply with the provisions of this chapter.

"(b) Transmission of plan and modifications.—As soon as practicable after the plan or any modification of the plan has been filed, the court shall set a time, which shall be ninety days from the filing of the plan or any modification of the plan, unless the court, for good cause, sets some other time, within which creditors may accept or reject the plan and any modification of the plan. The petitioner or such other person as the court designates shall transmit by mail a copy of such plan or modification, or a summary and any analysis of such plan or modification, a notice of the time within which the plan or modification may be accepted or rejected, and a notice of the right to receive a copy, if it has not been sent, of such plan or modification, to each creditor whose claim is affected by the plan, to each special tax payer affected by the plan, and to any party in interest that the court designates. Upon request by a recipient of such summary and notice, the petitioner or such other person as the court designates shall transmit by mail a copy of the plan or modification to that recipient. The court shall, after hearing on notice, determine any controversy as to whether a claim of a creditor or class of creditors is a claim affected by the plan and as to whether a special tax payer is a special tax payer affected by the plan. Notice, hearing.

11 USC 411. "Sec. 91. Provisions of Plan.—A petitioner's plan may include provisions modifying or altering the rights of creditors generally, or of any class of them, secured or unsecured, either through issuance of new securities of any character, or otherwise, and may contain such other provisions and agreements not inconsistent with this chapter as the parties may desire, including provisions for the rejection of any executory contract or unexpired lease.

11 USC 412. "Sec. 92. Acceptance.—

"(a) Who may accept or reject.—Unless a claim of a creditor who is included in the list or in a supplement to the list filed under section 85(b) or who files a proof of claim and whose claim is not then disputed, contingent, or unliquidated as to amount, or of a security holder of record as of the date of the transmittal of information under section 90(b), has been disallowed or is not a claim affected by the plan, that creditor or security holder may accept or reject the plan and any modification of the plan within the time set by the court. Notwithstanding an objection to a claim, the court may temporarily allow such claim in such amount as the court deems proper for the purpose of acceptance or rejection under this section.

"(b) General rule.—Except as provided in subsection (d), the plan may be confirmed only if it has been accepted in writing by or on behalf of creditors holding at least two-thirds in amount of the claims of each class allowed under section 88 and more than 50 percent in number of the claims of each class allowed under section 88.

"(c) Computing acceptance.—The two-thirds majority required by subsection (b) is two-thirds in amount of the claims allowed under section 88 of creditors who file an acceptance or rejection within the time fixed by the court, but not including claims held or controlled by the petitioner, or claims of creditors specified in subsection (d). The more than 50 percent required by subsection (b) is more than 50 percent in number of the claims allowed under section 88 of creditors who file an acceptance or rejection within the time fixed by the court, but not including claims held or controlled by the petitioner, or claims of creditors specified in subsection (d).

"(d) Exception.—It is not requisite to the confirmation of the plan that there be such acceptance by any creditor or class of creditors—

"(1) whose claims are not affected by the plan;

"(2) if the plan makes provision for the payment of their claims in cash in full; or

"(3) if provision is made in the plan for the protection of the interests, claims, or lien of such creditor or class of creditors.

"(e) Acceptance of modification.—If the court finds that a proposed modification does not materially and adversely affect the interest of a creditor, the modification shall be deemed accepted by that creditor if that creditor has previously accepted the plan. If the court determines that a modification does materially and adversely affect the interest of a creditor, that creditor shall be given notice of the proposed modification and the time allowed for its acceptance or rejection. The number of acceptances of the plan as modified required by subsection (b) shall be obtained. The plan as modified shall be deemed to have been accepted by any creditor who accepted the plan and who fails to file a written rejection of the modification with the court within such reasonable time as shall be allowed in the notice to that creditor of the proposed modification.

Notice.

11 USC 413. "Sec. 93. Objection to Plan.—A creditor who holds a claim affected by the plan or a special tax payer affected by the plan may file with the court an objection to the confirmation of the plan. The Securities

and Exchange Commission may also file with the court an objection to the confirmation of the plan, but in the case of an objection filed under this section, the Securities and Exchange Commission may not appeal or file any petition for appeal. An objection to the confirmation of the plan may be filed with the court any time prior to ten days before the hearing on the confirmation of the plan, or within such other times set by the court.

"SEC 94. CONFIRMATION.— 11 USC 414.

"(a) HEARING ON CONFIRMATION.—Within a reasonable time after the expiration of the time set by the court within which the plan and any modifications of the plan may be accepted or rejected, the court shall hold a hearing on the confirmation of the plan and any modifications of the plan. The court shall give notice of the hearing and of Notice. the time allowed for filing objections to all parties entitled to object under section 93. The court may, for cause shown, permit a labor union or employees' association, that represents employees of the petitioner, to be heard on the economic soundness of the plan affecting the interests of the represented employees.

"(b) CONDITIONS FOR CONFIRMATION.—The court shall confirm the plan if—

"(1) the plan is fair and equitable and feasible and does not discriminate unfairly in favor of any creditor or class of creditors;

"(2) the plan complies with the provisions of this chapter;

"(3) the plan has been accepted as required by section 92;

"(4) all amounts to be paid by the petitioner or by any person, not including other governmental entities, for services and expenses in the case or incident to the plan have been fully disclosed and are reasonable;

"(5) the offer of the plan and its acceptance are in good faith; and

"(6) the petitioner is not prohibited by law from taking any action necessary to be taken by it to carry out the plan.

"SEC. 95. EFFECT OF CONFIRMATION.— 11 USC 415.

"(a) PROVISIONS OF PLAN BINDING.—The provisions of a confirmed plan shall be binding on the petitioner and on any creditor who had timely notice or actual knowledge of the petition or plan, whether or not such creditor's claim has been allowed under section 88, and whether or not such creditor has accepted the plan.

"(b) DISCHARGE.—

"(1) The petitioner is discharged from all claims against it provided for in the plan except as provided in paragraph (2) of this subsection as of the time when—

"(A) the plan has been confirmed;

"(B) the petitioner has deposited the money, securities, or other consideration to be distributed under the plan with a disbursing agent appointed by the court; and

"(C) the court has determined—

"(i) that any security so deposited will constitute upon distribution a valid legal obligation of the petitioner; and

"(ii) that any provision made to pay or secure payment of such obligation is valid.

"(2) The petitioner is not discharged under paragraph (1) of this subsection from any claim—

"(A) excepted from discharge by the plan or order confirming the plan; or

"(B) whose holder, prior to confirmation, had neither timely notice nor actual knowledge of neither the petition nor the plan.

11 USC 416. "Sec. 96. Postconfirmation Matters.—

"(a) Time allowed for deposit under the plan.—Prior to or promptly after confirmation of the plan, the court shall fix a time within which the petitioner shall deposit with the disbursing agent appointed by the court any consideration to be distributed under the plan.

"(b) Duties of petitioner.—The petitioner shall comply with the plan and the orders of the court relative to the plan, and shall take all actions necessary to carry out the plan. The court may direct the petitioner and other necessary parties to execute and deliver or to join in the execution and delivery of any instrument required to effect a transfer of property under the plan and to perform such other acts including the satisfaction of a lien, as the court determines to be necessary for the consummation of the plan.

"(c) Distribution.—Distribution shall be made in accordance with the provisions of the plan to creditors whose claims have been allowed under section 88. Distribution may be made at the date the order confirming the plan becomes final to holders of securities of record whose claims have not been disallowed.

"(d) Compliance date.—When a plan requires presentment or surrender of securities or the performance of any other action as a condition to participation under the plan, such action shall be taken not later than five years after the entry of the order of confirmation. A person who has not within such time presented or surrendered that person's securities or taken such other action required by the plan shall not participate in any distribution under the plan, and the consideration deposited with the disbursing agent for distribution to such person shall become the property of the petitioner.

"(e) Continuing jurisdiction.—The court may retain jurisdiction over the case for such period of time as the court determines is necessary for the successful execution of the plan.

"(f) Order or decree as evidence and notice.—A certified copy of any order or decree entered by the court in a case under this chapter shall be evidence of the jurisdiction of the court, the regularity of the proceedings, and the fact that the order was made. A certified copy of an order providing for the transfer of any property dealt with by the plan shall be evidence of the transfer of title accordingly, and, if recorded as conveyances are recorded, shall impart the same notice that a deed, if recorded, would impart.

11 USC 417. "Sec. 97. Effect of Exchange of Debt Securities Before Date of the Petition.—The exchange of new debt securities under the plan for claims covered by the plan, whether the exchange occurred before or after the date of the petition, does not limit or impair the effectiveness of the plan or of any provision of this chapter. The written consents of the holders of any securities outstanding as the result of any such exchange under the plan shall be included as acceptances of such plan in computing the acceptance required under section 92.

"SEC. 98. DISMISSAL.— 11 USC 418.

"(a) PERMISSIVE DISMISSAL.—The court may dismiss the case after hearing on notice—

"(1) for want of prosecution;

"(2) if no plan is proposed within the time fixed or extended by the court;

"(3) if no proposed plan is accepted within the time fixed or extended by the court; or

"(4) where the court has retained jurisdiction after confirmation of a plan—

"(A) if the petitioner defaults in any of the terms of the plan; or

"(B) if a plan terminates by reason of the happening of a condition specified therein.

"(b) MANDATORY DISMISSAL.—The court shall dismiss the case if confirmation is refused.".

SEC. 2. SEPARABILITY.—If any provision of this chapter or the application thereof to any agency, instrumentality, or subdivision is held invalid, the remainder of the chapter, or the application of such provision to any other agency or instrumentality or political subdivision shall not be affected by such holding. 11 USC 401 note.

SEC. 3. If the amendment made by this Act is judicially finally determined to be unconstitutional then chapter IX of the Bankruptcy Act, as such chapter IX existed on the day before the date of enactment of this Act, is revived and shall have full force and effect with respect to cases filed after such determination. 11 USC 401 note. 11 USC 401 et seq.

Approved April 8, 1976.

LEGISLATIVE HISTORY:

HOUSE REPORTS: No. 94-686 (Comm. on the Judiciary) and No. 94-938 (Comm. of Conference).

SENATE REPORT No. 94-458 accompanying S. 2597 (Comm. on the Judiciary).

CONGRESSIONAL RECORD:

Vol. 121 (1975): Dec. 9, S. 2597 considered in Senate; considered and passed House.

Dec. 10, considered and passed Senate, amended, in lieu of S. 2597.

Vol. 122 (1976): Mar. 25, House receded and concurred in Senate amendments with amendments; Senate agreed to conference report, concurred in House amendments.